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Thinking for the future

New Zealand Income Tax:

Unfair and favours the rich

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Preface

If we close the worst of the loopholes in our income tax system we'll not have to collect as much tax from salary and wage earners. Taxation will become more fair and capital will become more productive.

Rising inequality in New Zealand is most evident when measured by net worth, rather than income. Although there is a paucity of data about net worth, what information there is suggests some of New Zealand's most wealthy people, persistently and consistently, have relatively modest taxable incomes.[1] So it's wealth (net worth) we should be watching.

A rise in inequality (however measured) is not necessarily a bad thing. It may simply reflect the dynamics of a modern economy where those who innovate get exceptional rewards for exceptional effort. Think Steve Jobs or Peter Jackson. In theory anyway, the exceptional rewards aren't necessarily long-lasting – the innovator might have been a one-hit wonder who has a much lower income in the future. But as long as there is a continual stream of innovation delivering exceptional incomes to someone, we can always expect income inequality in a modern market economy. That's one possible explanation for the rising inequality evident in New Zealand. But there are other, more likely, explanations for rising inequality too – and these are more sinister.

Inequality occurs when some groups in society have enough political clout to secure important economic privileges such as being exempted from tax or receiving substantial amounts of public money or regulatory protection for their earning activities. This type of inequality reflects entrenched power divisions in society and so is more likely to persist from one generation to the next. Such privilege reveals itself as an increasing concentration of net worth.

This paper is concerned about two of the glaring gaps - deliberate loopholes - in New Zealand's income tax regime. These loopholes have persisted for many decades and have contributed to a rising concentration of wealth, particularly but not exclusively, held in the form of property assets. These loopholes have distorted investment and income, and ultimately undermined the growth potential of the economy. Not surprisingly, these loopholes are of increasing public concern as well.

The proposal here is reform of the income taxation regime. The reform I suggest is not incremental, it is fundamental. I propose that New Zealand moves from a tax regime that confers privilege and amplifies inequality, to one that supports equality of opportunity, freedom of choice, and higher living standards. Such a radical change will, of course, have to be introduced carefully as there will be important transition issues.

This paper is based on work initiated in the 2011 publication of the book, "The Big Kahuna", and updates and refines one side of the tax and welfare reforms proposed in that work.[2] It is part of a project that looks at the need for even wider taxation reform and considers options for reform of social welfare. The intention is to produce a sequel to The Big Kahuna, late in 2016.

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Introduction

Ensuring the tax base is as large as possible for a certain tax, not only maximises fairness through minimising exemptions, it lowers tax rates overall and with that disrupts decision-making by households and businesses as little as possible. New Zealand is internationally applauded for taking this approach with our GST tax. However our income tax regime is undermined by some major loopholes and these are promulgating unfairness and inequality, impeding economic growth and the generation of income for New Zealanders. To close these loopholes will require slaying some sacred cows and disrupting long-held privileges bestowed on a capital-owning elite. But the dividend to society will be well worth the disruption.

The first income tax loophole addressed in this paper arises from how income is defined for tax purposes. The current definition of income used by IRD excludes from tax, some of the benefit received by owners of capital. Despite being recognised in the National Income Accounts as genuine income, some forms of income are not taxed. The second loophole that is addressed is one that extends to foreign-owned enterprises, providing them with an easy avenue to dodge their tax obligations in New Zealand.

Three of the desirable properties of a taxation system are that it be fair, neutral and economically efficient. The New Zealand income tax regime is none of these things.

Fairness

There are many definitions of ‘fairness’ but in the context of tax policy the concept is straightforward: treating people equally without favouritism or discrimination. The effective average tax rate paid on salary and wages is 18%, that on other forms of income to households averages just 12%, while the effective tax rate paid on corporate incomes, always hard to measure, appears to be around 16%. These average tax rates are based on government revenue data and income estimates from the National Income (or “GDP”) Accounts. On the face of it these varying rates of income tax are unfair. However they are the reality and one of the two reasons our income tax system is overdue for reform.

How does such a disparity arise given we are all covered by the same tax regime? The disparity reflects a deliberate decision by successive governments not to tax some forms of income. The scale of this deliberate omission is made very clear when the GDP accounts are used as a comparator for tax receipts. The GDP accounts recognise more forms of income than merely cash (less expenses) received. Most significantly, the income measure includes the very real services provided by housing to owner-occupiers – by deeming an income, equivalent to rent, is enjoyed by them.

The non-cash income measure in the GDP accounts should not in theory be limited to imputed rent from owner-occupied housing – it should include imputed annual benefits from all owned capital – boats, motor vehicles, artworks, jewellery, etc. The only reason these benefits are not included is the difficulty of measurement. Further, all household production should be included, not merely that wherein cash is exchanged. So meals cooked and consumed in the home, DIY home maintenance, child and elder-minding etc should all be part of the GDP income measure.

By omitting much of what occurs within the household, GDP income measures ignore the substantial contribution made by unpaid household and volunteer workers. This deficiency in the GDP accounts is well recognised and continues to be an area of growing concern by economists. As recently as this year the London magazine, The Economist, described GDP as

> “a deeply flawed gauge of prosperity, and getting worse all the time”. [3]

GDP accounts then are at best, a partial picture of production, income and consumption each year but they at least reflect the very real accommodation services provided by dwellings. The GDP accounts cannot ignore the benefit from owner occupation of housing simply because it is so large. Estimates for 2015 suggest it is around 10% of all household “income”.

Parliament’s decision to turn a blind eye to the very real economic benefits received by home-owners instills a massive unfairness in our tax regime. The effective income benefit that owner-occupiers enjoy from their ownership of housing is very real yet it’s untaxed. If you put $500k into a bank you are taxed on the benefit you receive (interest), but if you buy a house with it you are not (yet the accommodation services received are real). Both are benefits received, why should one be taxed and not the other? The answer, is that our tax system is largely a cash-based system, a significant problem which was recognised in 2001 in the McLeod Tax Review and raised again in 2010 by the Tax Working Group. [4,5] The limited definition of ‘income’ that underpins the New Zealand tax system is a likely contributor to the rise in inequality witnessed in New Zealand.

Internationally, the single most significant contribution to the growing within-country inequality of recent decades has been shown to be the benefits accruing from the ownership of land and housing.[6] So an income tax regime that ignores the benefit accruing to owners of property exacerbates the inequality that arises from this source.

The effective tax rates reported earlier point to an added problem. If you have different tax rates for different sources of income then that is not only unfair, it leads to tax-minimising shifts in investment. Investors are incentivised to invest in activities that produce income which is ignored by the IRD. To reduce this economic distortion we need to include the benefit that accrues to all property owners at least, in taxable income – whether it's the home, the bach, the second home, the business premises, etc.

Neutrality

Indeed to be consistent – rather than just pick on land and housing – the benefit that accrues to owners of any productive capital should be considered taxable income – whether it materialises in cash or in kind. As pointed out earlier, as well as the benefits to owners from capital not being fully included in measures of national income (GDP), the production and consumption of goods and services by households for own use – or bartered with others – is commonly excluded too. They are excluded as well from the income tax regime.

A neutral tax impost would capture all of these, enabling the annual tax collect to be obtained at lower tax rates than prevail currently. However there are limitations to the practicality of this. We'll discuss those later.

Economic Efficiency

The decision to omit some forms of income from the tax system is a political one. It reflects the political power of property owners. As such, the policy is an example of financial privilege being afforded one group of society. There is nothing economically beneficial ('efficient' in economists' jargon) about privileges bestowed for political reasons and the inequality that results has no economic justification.

Inequality that arises from political privilege or protection sponsors rent-seeking (pecuniary benefit without providing any benefit to society in return) and produces economic rigidities. The inequality produced by protection and privilege is 'inefficient inequality'. It stands in stark contrast to inequality that arises because of effort or innovation. In this latter case, inequality reflects the extraordinary rewards earned by those who make an exceptional effort or technological breakthrough and is socially useful. Efficient inequality stimulates economic prosperity as people respond to the incentive to do better.

Over recent years there has been a burst of evidence to demonstrate that the rigidities arising from inefficient inequality are lowering labour mobility and reducing the equality of opportunity. These rigidities are fuelling greater inequality and presenting a drag to economic growth. [7,8]

A policy of privileging some New Zealanders via the income tax regime is inefficient in this sense, spurring on a misallocation of capital as investors respond to the incentives such discrimination presents, and over time producing a greater and greater concentration of market (and political) power. Recent work showing that inequality arising from a concentration of market power has a tendency to snowball, dragging back economic growth as a result, should be of grave concern. [9,10]

A taxation regime that promotes inefficient inequality runs counter to the belief that free market capitalism (where freedom of entry to, and exit from, markets is fundamental) is the most fair and efficient economic system.

B: Comprehensive Capital Income Tax (CCIT)

B1: What is CCIT and why is it needed?

A comprehensive capital income tax (CCIT) was proposed in the 2011 book, "The Big Kahuna" written by Gareth Morgan and Susan Guthrie [op cit]. The CCIT bears many similarities to the tax reforms tabled in the 2001 McLeod Tax Review [op cit]. The essence of the idea is that income is received by people in more ways than just cash, and if a tax regime fails to acknowledge this, anomalies in the way the tax burden is shared are unavoidable.

Such anomalies attract investors to favour certain assets for tax-light reasons as opposed to economic returns. That misallocation impairs the economy's performance. A strong example is the over-investment in housing where the demand is related more to expectations of future investor demand than anything to do with accommodation needs. Today's property price-to-income levels are significantly higher than they were 50 years ago, and there are reasons to believe they are now at levels well above what the demand for accommodation alone would imply.

Arguably the biggest hole in the income tax base is the absence of non-market income, or income that is produced from applying the capital stock in a way that generates a return for the owner, which the owner then consumes. Nobody would suggest that these non-cash or in-kind items – which are after all included in the recognised measure of national income - are not real.

This single distortion has arguably been the source of the greatest disturbance in allocation of capital in capitalist economies over recent decades.[Rognlie op cit]. In the property market, the tax wedge favours ownership over renting to a degree that would not exist if both forms of rental income were taxed. Further, this distortion has underpinned a demand for property ownership that is quite apart or separate to any demand for accommodation, resulting in a quite different allocation of capital than would otherwise be the case. The tax incentive has a lot to answer for.

And there are bound to be knock-on effects from this somewhat arbitrary selection of income items to be zero-rated. Take GST for example. In New Zealand GST (our tax on added value) is not applied to rent income from residential property.[11] The reason given is that drawing rent into the tax regime would exacerbate the distortion that already exists between tenants (whose rent is taxed as income in the hands of the landlord) and owner-occupiers (whose rental benefit is not). This is an explcit acknowledgement of the distortion that our income tax regime suffers by not including imputed rent.

The reasons the income tax base is restricted to cash income items only have been numerous

(a) it would impose a cash-flow demand on those who receive a benefit from the imputed income or use-of capital items, but that benefit is not in cash

(b) it would complicate tax accounting by requiring computation of what the imputed benefit is each tax period

(c) there are boundary issues around where the income might be deemed no longer or is too little to accrue – for example owner-occupied houses may be the largest capital item to bestow imputed income, but how about other capital items that last more than a tax period – a pencil or a cellphone for instance? Should only the user services from those items be regarded as income and expenditure each year rather than the whole item (as is the convention for consumption goods)?

(d) Similarly, what about services provided for own use – cooking and then consumption of meals for instance? Should the voluntary labour be valued and tax paid on the market value equivalent of the item produced for own-consumption? If that activity was in the cash economy the producer would have assessable income and the consumer would be paying for the item from tax paid income. GST would also be liable on the labour content of the meal.

The larger the tax base the lower the tax rates required, so by including all of the above in the tax base one could expect the significance of the tax wedge on any transaction to be reduced, thus contributing to an improvement in economic efficiency from the more neutral incidence of tax.

Now it follows that this more comprehensive measure of the income base would present issues for the taxation authority. It would have to differentiate between those costs incurred for the purpose of procuring income and those costs incurred for the purpose of final consumption. How many of your meals would you not need if you weren't physically working for example? How many deductions are you claiming that really are not legitimate costs of procuring this 'notional' income? Currently none of those costs are deductible to the household against their taxable income (unless they are running a cash-generating business from home that those expenses can be justifiably attributed to).

It gets more complex again if we decide to measure GDP or National Income comprehensively and include all the services produced by the voluntary workforce in the household sector – care of family members, for example. These services are all produced for and consumed within the household sector. Famously the current situation is that a housekeeper's labour 'disappears' from GDP if the housekeeper marries the householder and payments cease. While the payment made to the volunteer is zero, the benefit to the recipient certainly is not and could be assessable as income. The neutrality principle of taxation would suggest there should be an income tax wedge working in there just as there is when the services rendered are paid for with cash.

On this issue of taxing income from own-production that is consumed by the producer so no cash income is generated, there is a test of practicality to consider. Currently this type of income is exempt – and the costs of production are not deductible - but they do incur GST (meal ingredients incur GST for example). In the absence of any obvious adverse and significant consequences from this, it's not pragmatic to include such activity in the income tax base as well. This is quite contrary to the situation around tax breaks for productive capital, where there's plenty of *prima facie* evidence of significant macro consequences such as the over-investment in housing at the expense of other assets.

So in summary, our current cash-based definition of assessable income is only a partial measure of effective income and, because of this, the income tax regime is unfair and society's income is lower overall as a consequence.

Many countries try to address this anomaly between the owners of capital and the rest of society. Wealth taxes, deemed income for taxation purposes, inheritance taxes, gift duties, stamp duties are all examples.

B 2: What do we get from it? – lower tax rates, higher growth, fairer society

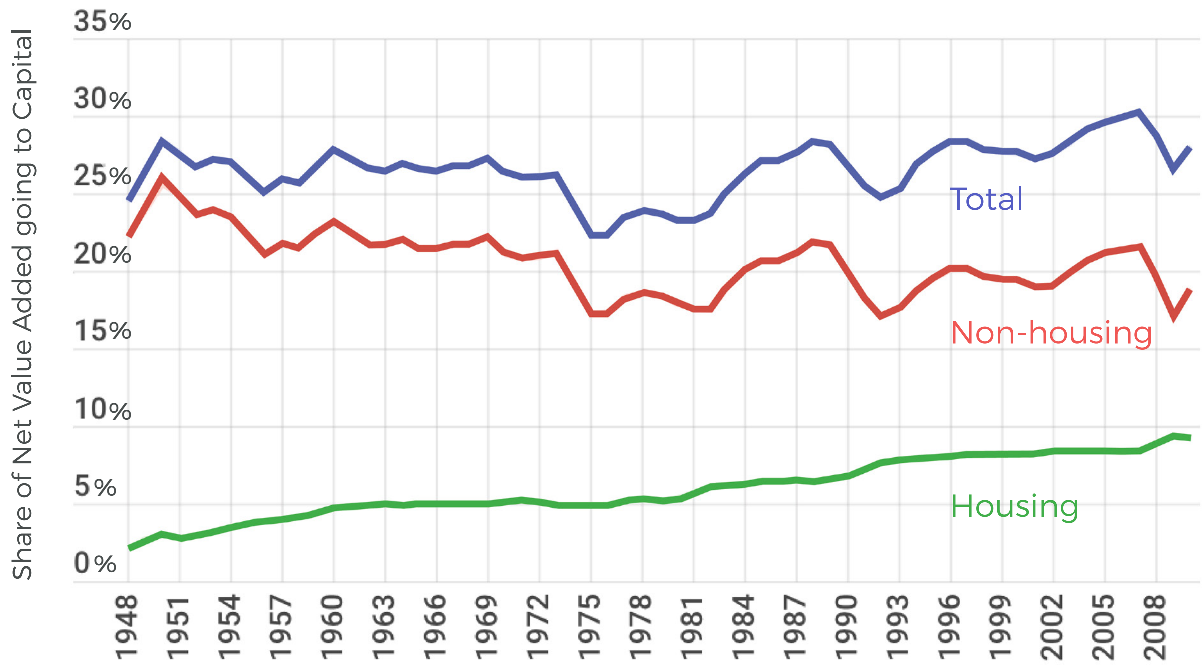
As we discussed in B 1, the rationale for the CCIT is to close those deliberate concessions in the taxation regime. Tax neutrality should only be compromised if the government has a desire to impose "corrective" taxes to discourage some activities for the sake of others. Imposing excise duties on cigarettes, alcohol, fossil fuels could be examples. Failure to tax all the economic benefit that owners of capital enjoy, does not satisfy this test.

On the other hand it is difficult to argue that recent governments have had a deliberate policy to promote investment in property over other business investment (it may have been true of early post-War governments). Yet by absenting the owner-occupier benefit of property ownership from tax, and further favouring that asset class by prudential rules on lending that favour banks issuing mortgages over other debt types, there is little doubt that a cumulating benefit to property owners has ensued – in many developed countries over several decades.

The work of Rognlie [op cit] illustrates just how pervasive the role of property has been in the driving the apparent excess return to capital over labour during recent decades. The graph illustrates how it's only when the share of income accruing to property is included can it be argued, as Picketty did in his 2014 book, that the share of national income accruing to capital has risen.[12]

Housing is the driver of rising inequality

Data from US, Canada, Germany, UK, Italy, Japan 1948-2010 - Courtesy of Matthew Rognlie



The CCIT then – wherein productive capital that is deployed for own-use or alternatively does not furnish an adequate taxable income, is deemed by society to furnish the owner a certain level of income that is assessable for income tax purposes. The CCIT serves to reduce if not fully remove the existing taxation distortion and boost economic growth and fairness.

B 3: How is CCIT levied?

We begin from the philosophical position that all capital or accumulated savings should be at work and earning at least a rate of return equivalent to the risk-free rate (the rate at which the government – with its monopoly power to tax and pay its creditors back can borrow).

Now of course much of the accumulated savings is at work – people may deposit money in the bank that is then lent out at a rate of interest which, after deduction of the bank's cut, is their reward for enabling others to utilise their savings. And the government taxes that interest in the hands of the recipient. Alternatively folk may invest in companies in return for a (taxable) dividend – that is the reward for putting those savings to work.

But providing your savings to others to use in return for a dividend or interest payment is only one avenue to use your savings. You may instead choose to purchase capital directly yourself (structures, land, equipment, intellectual property), and either lease that capital out for a (taxable) fee or you may choose to use it in a business directly yourself in which you reap (taxable) profits. But you may also choose instead to enjoy the annual services the purchased capital provides. For example a house provides you with its (non-taxed) accommodation services, a boat with its (non-taxed) leisure for fishing and cruising, a car or motorcycle with its (non-taxed) transport or cruising services, a horse with its (non-taxed) riding time, and so on.

While it is fine for people to choose to consume the services that capital provides directly, rather than rent that capital out or invest their savings, it does give rise to an anomaly. Deriving a benefit from the deployment of that capital is a taxable activity in some cases but not in others.

Then there is the issue of the efficiency of use of capital. Sometimes capital just lies about not being used or being under-utilised. That imparts an economic cost to the economy – in the form of employment and income that is not occurring because the capital is idle. In an economy such as ours where there are citizens whose aspirations – material and other – remain unfulfilled, or worse people are in poverty, that under-utilisation of capital has a very real human consequence.

The proposition of the CCIT is that own-use of (non-financial) capital provides an assessable income depending on whether the owner lets the capital lie idle, underutilised or enjoys the full benefit of its services. But in all cases, that benefit should be taxed – at least to the extent that the income from it could be at least equal to the risk-free rate the economy is offering.

Let's illustrate by taking a car as an example – the owner can rent it out, use it in her business that produces a cash income, drive it for pleasure, or leave it idle in the garage. In only two of the four cases is the service the car produces assessable for income tax. Yet in all four cases the owner could reap a benefit.

The concept of the CCIT is that in all four cases the car's services are available as income for the owner and therefore assessable for income tax. For the two cases where there is no cash income, the question becomes how much assessable income should be deemed.

We know what rate of return the owner could earn with no risk at all from the amount she's invested in the car so the assessable income should be set at least at that rate. In a world of long term government bonds offering yields of 5% then, a 5% income on the car is a minimum that could be assessable. The value of the car is available from the statutory depreciation schedules, or market prices, while the owner can only be expected to declare an income that accords to the equity they own in the equipment. If there is debt registered against the vehicle that will already be reaping taxable income for the lender so no need to tax it twice.[13] This approach is an alternative to the tax authority deeming that the 5% rate of return should apply to the full vehicle (depreciated) value but have the interest bill on any debt deducted.

The point of this approach to taxation of income from capital is twofold; to ensure that all effective income is taxed (this is the argument for a tax regime that is equitable); and to raise the utilisation of capital (this is the economic efficiency argument).

In practical terms the tax assessment would require every economic entity to provide a schedule of assets and debt each year. Then for assessable income purposes, the CCIT is applied to the owner's net equity in the asset. So if a 5% return is assumed and the relevant income tax rate (20% for instance) is applied to that deemed income, then each and every year then, the owning entity's CCIT liability is 1% of the aggregate depreciated net (i.e. less debt) capital they own.

If the entity already generates taxable income that is subject to income tax then that tax can be netted from the assessed CCIT – so the CCIT could be as low (but not less than) zero.[14] This simply ensures that capital-owning business entities pay at least the tax they would by investing that capital at the risk-free rate.

One question is at what asset value the CCIT cuts in – does it apply to pencils for example? Ultimately this is a political question but a minimum asset schedule of $200,000 and a $10,000 per capital item lower threshold, may be a practical floor for individual personal owner/taxpayers. For multi-owner (Partnerships or Trust) assets the floor might be $200,000 per capital item. A property worth $5m say with 100 beneficial owners would attract CCIT on $4.8m, irrespective of individual owners' proportional interest. For incorporated taxable entities there would be no need for the $200k exemption.

To illustrate, a couple that jointly owned one $40,000 and one $8,000 car, and a boat worth $10,000, and had $350,000 equity in a house (say the house was worth $600,000 but they had a mortgage of $250,000), would be assessed as having $400,000 of net worth (the cheaper car would not be counted). Using a risk free rate of 5% and a tax rate of 20% CCIT of $4,000 would be payable.

A CCIT applied at these rates in New Zealand would expand the income tax base by the order of at least 20%. In other words it could finance a drop in income tax rates across the board of the same – for example, the average tax rate on salary and wages of 18% could fall to something closer to 14%. And of course the politicians of the day would decide exactly who to favour most in that tax cut.

B 4: How do we transition?

The CCIT is a major change in the way income tax is conceived. It requires capital owners to adopt a different cashflow profile. The scope to accumulate capital on the balance sheet without generating concomitant cash income, will be tempered by the annual tax impost that underutilised capital (capital that doesn't even earn the risk-free rate) attracts.

So the tax liability for capital-intensive businesses that do not earn a profit at least equivalent to the risk free rate would rise under CCIT. The CCIT would require them to rationalise their capital by either selling it or employing it more efficiently. One might expect the transition from the status quo for such a business to involve significant restructuring.

For example consider a farm that fails to reap the risk-free rate of return on owned assets. The farmer would either have to accept an even lower after-tax return as their tax obligations rise, or they'd endeavour to reduce the capital they are deploying more than they reduced income (by a sell-down say), or they would raise productive efficiency to boost income. All three options would improve the economy – the first by providing more tax revenue, the second by moving the assets into more productive hands, the last by directly boosting the productivity of the asset.

In the case of a private citizen , if they didn't wish to pay the tax due on the benefits they received from the equity in their assets, again the CCIT would lead to them sell down underutilised assets – freeing them up to be used elsewhere. If they simply didn't have the cashflow, then the CCIT would necessitate them to rearrange their portfolio of owned assets so they did have the required number of cash-earning assets to cover the tax liabilities of the ones that they deployed for own-use. Again it would ensure that the capital owner doesn't waste capital by having it lie underutilised – they would be incentivised to ensure that all assets they owned were returning a benefit to the owner – either in cash or in kind.

Without doubt the transition will be a disruption for businesses and citizens that have assets lying about underutilised or which provide sizeable in-kind benefits to the owners. But every asset can be thought of as an economic asset that could – if it weren't idle – produce benefit for the economy. So the transition from a world where owners of capital are encouraged to accumulate assets not because of their economic return but rather their scarcity value, would be a transition necessitating review by many of their rationale for asset-hoarding. The resultant productive boost for the economy can only be good for employment and alleviation of poverty.

B 5: CCIT and assets used only partly for business, if at all.

Because the CCIT is a tax that recognises the income or benefit from all productive assets that could alternatively, be applied to generating cash (by renting them out), it will impact on the decisions made by individuals, self-employed, family trusts, NGOs, Maori ownership entities, managed funds and all non-profit organisations (with the exception as now of government-owned, social enterprises).

What in effect the CCIT requires is all taxpayers to present a balance sheet of what they own and owe as part of their tax return. As noted above, a minimum per item threshold may be pragmatic. The values for each capital item can be obtained either from the depreciation schedules that businesses use for their annual returns, or alternatively, as the insured value of the item – whichever is the greater.

For the purposes of the CCIT, a taxpayer applies the tax rate to 5% of the net value of (i.e. non-financial) assets (that is, the depreciated value of the assets less debt). Double taxation is avoided by ensuring that any tax to pay on income produced by the assets on the schedule is credited against CCIT (or vice versa). The tax due overall from the assets is the tax due on cash income received from deployment of the asset subject to a minimum 5% return being applied to the net equity value.

The expansion of the income tax base to include assets owned by non-businesses (subject to any minimum threshold) is a significant expansion of the tax base. Of course implemented by itself, the whole CCIT proposal can be tax neutral by offsetting it with a reduction in income tax rates.

One question sometimes raised is what about assets deliberately 'locked up' in perpetuity for ecological reasons say – a QEII-covenanted block of land for instance? My take on that is they would be subject to CCIT but clearly the owner can avoid that burden by passing ownership to the State.

The mixing of business and personal assets is common – for example on family farms and among other self-employed people. The CCIT would require these owners to augment their current tax return by including that portion of qualifying assets they own for private use, so CCIT can be assessed. Currently the approach is only to claim as an expense the costs associated with using the asset for income-earning purposes. The current regime ignores the full benefit received from ownership – although FBT is a somewhat imperfect attempt to bring into the tax net private benefits from assets owned or expenses incurred by businesses.

B 6: Where does the cash to pay CCIT come from?

On this, think about CCIT in an analogous way to property rates – but rather than being simply an annual impost on the owner of land and buildings, it is applied to the equity in all productive or non-financial capital which provides a return of some form (in cash or in services) to its owner.

Owners of land and buildings have to arrange their overall portfolio so that they have sufficient cash to pay their rates each year. The CCIT requires exactly the same. What we would expect is for owners of currently non-taxed capital to have to rearrange their financial affairs in order to pay tax on the benefit they receive via ownership.

We often hear of asset-rich, cash-poor owners of property, farms and other assets. Of course these people are not irrational, it is a position they engineer deliberately in order to maximise their return or benefit from ownership. In the instances where that comes in the form of tax-free capital gain, the paucity of cash is a risk taken in order to maximise the overall benefit or return – which, quite unfairly is not taxed (except in special circumstances where the owner declares it was their intent to make a profit from capital gain, a step only taken by those whose frequency of trading assets makes it difficult to deny that intent).

In the case where the return is a non-cash one, in the form say of own-use of an owner-occupied dwelling, then the benefit is clearly that the owner, while forgoing taxable interest in the bank, is instead enjoying the rental services from the owned dwelling. The tax base currently captures the return on the deposit, but not the return or service provided by the dwelling. That is a loophole and unfair.

By requiring owners of capital to take into account the cashflow implications of an annual impost under CCIT, we would expect the price of property for example to be lower than would otherwise prevail – the reason being that the after-tax return from ownership will be lowered. This will improve the alignment of house prices with the demand for accommodation, as opposed to the status quo where property prices reflect more the combined benefit anticipated from tax-free capital gain and the tax break afforded the benefit from accommodation received each year by owner-occupiers.

The cash required to meet the annual CCIT impost can be expected to be available from owners who rearrange their portfolios to include more cash-earning assets. It may well be reasonable to allow owners in certain circumstances to defer their CCIT for a limited period (so long as use of money interest is charged) until they sort their cashflow. This type of circumstance could include a loss-making year for a business, or even a year where profit is made but cashflow is tight because of investment outlays say. Another circumstance might be a homeowner who is waiting for a liquidity event such as an asset sale in order to meet their tax obligations. But it’s an important principle to ensure in these cases there is no free ride for the owner so charging them use-of-money interest at market rates would be appropriate. It may be appropriate in some circumstances for the owner to grant the IRD a charge over the asset as well.

B 7: What happens to home owners who have invested on the expectation of tax-free capital gain?

This is a question about transition from the current regime to the CCIT regime. A related question is by how much we might expect property prices to correct in a world without the tax loophole owners currently enjoy. It will be less than if that loophole were completely removed – the CCIT does not fully tax the accommodation benefit that owner-occupiers enjoy. To do that it would tax the market rental equivalent of the property, whereas under CCIT what is taxed is 5% of the property value.[15] Rental yields would be above the risk-free rate in a world of tax-neutrality, reflecting the risk of the asset class.

Anyway, even a partial closure of the loophole (as CCIT brings about) can be expected to lower property prices. By how much depends on how much of the current demand is driven by what owners currently expect to make over time from tax-free capital gain. That depends on location or course and anticipated population growth and buyer pressure. The amount is indeterminate without making arbitrary assumptions around how speculators discount expected future wealth gains compared to current cashflow, or without knowing how much of the return currently is achieved already via taxable means. The greater that is, the less the reduction in capital value that can be expected.

In summary, the introduction of a CCIT-based income tax regime will adversely affect the capital value of property for some, that fall conferring equivalent benefit to prospective property owners in the form of a reduced cost of entry to the market. It is then in essence a wealth transfer, the extent of the transfer will depend on the extent of the proportion of return (financial and other) that is already in taxable form.

It is a current market reality that rental yields of higher valued properties are lower – which itself reflects the demand from higher income owner-occupiers for the tax-free benefits and ownership rights over the 'luxury comforts' conferred. On financial grounds alone one might expect then the capital impact of the CCIT to be greatest for these types of property – but it is not a given.

Unambiguously, demand for housing will align more closely with accommodation needs – how much closer is indeterminate.

B 8: Loss-making Businesses

One of the oft-heard objections to CCIT comes from owners of loss-making businesses. The question is where is the money is supposed to come from to pay the annual impost of CCIT?

Businesses of course are not supposed to make losses. A business that over time makes more losses than profits is a failure and should not continue to be treated as a business for taxation purposes. Under our current, partial, taxation regime however many "businesses" make losses or minimal profits permanently in order for the owner to minimise their tax liability while benefitting from 'expenses' deemed tax deductable. These are euphemistically referred to as "lifestyle" businesses and are in essence an evasion scheme. Of course it's not legal, but detection and policing is another matter.

CCIT makes the pursuit of lifestyle businesses altogether more difficult. There is a tax liability each year set at say 1% (20% of 5%) of the net value of the (non-financial) assets employed (net of debt). Such a cash flow impost would encourage the owner to make a profit at least equal to that required to offset the CCIT liability. It still doesn't address evasion but at least the taxpayer gets some toll revenue from such schemes. The importance of "legitimate business" tests remains.

As well, some legitimate businesses make losses from time to time and during those years cash can be tight. Other businesses might make a profit in a given year but have big cashflow demands from investment needs say. An additional tax obligation like CCIT might thwart such investment for growth.

Firstly, under the current tax regime a business that runs ongoing losses will eventually be identified by the IRD as not being a legitimate commercial enterprise. So endemic losses are not an option for a business anyway. Under a CCIT-augmented income tax regime, a business that makes a loss in any given year will still be liable for CCIT. But it has the option to either pay that tax as per normal or it can enter into a deferral arrangement, albeit at the cost of incurring 'use of money' interest (set at normal commercial rates).

So let's illustrate by example;

Janet and John Enterprise Inc has a balance sheet which identifies net equity of $12m invested in productive capital (structures, equipment, land, IP, etc).[16] But this year the business reports a pre-tax loss of say $1m. Under the current tax regime it would not be liable for tax.

Under the CCIT regime the business would still be liable for income tax calculated on a tax base of 5% of $12m ($600,000). Instead of carrying forward a tax loss of $1m J&J Inc can only carry forward a loss of $400,000.

B 9: Farming

Farming is an important industry for New Zealand as we all know, it provides a large portion of our foreign exchange earnings. Yet farmers often, though not universally, have low taxable earnings in comparison to the value of the capital assets they deploy to produce those earnings. For sure the objective is to earn more than the risk-free rate over time, sufficiently more to compensate for earnings volatility and other forms of risk. Otherwise it would not be rational.

Even if the profitability as per conventional profit and loss accounts never shows such a buffer for risk, it is reasonable to assume the farmer persists because of the lifestyle return – that is a euphemism for a return in kind (rather than cash). Not to seek such a level of return, however it is manifest, would simply be irrational.

In fact, a large part of the return to farming has come in the form of the appreciation of the value of the land and improvements and over the last 30 years that return has typically averaged 4% pa over and above inflation.

When the full return to farming is fully assessed the return is fine – in after-tax terms it averages 6-10% pa which provides a comfortable buffer over-and-above the risk-free, post-tax rate of return.

Phew, we can be confident that farmers are rational, they look at their post-tax return, satisfy themselves it is satisfactory for the risk taken and the market works!

Imposing the CCIT regime on farming then is unlikely to have any fundamental impact on the earnings of the sector – historically, the earnings have exceeded the 5% pa pre-tax equivalent of the risk-free rate. The extent to which a portion of that return has been capital gain may well change however as in effect capital gain capitalises the future (tax-paid) income stream and for those farms where the annual taxable income stream is less than 5% pre-tax, there would be an additional tax impost. Asset prices would adjust to reflect this.

To illustrate, let's do a worked example of a farming operation.
Janet and John own a dairy farm with 500 milkers, paid $24m for the farm and have no debt, and this year their taxable income is $960,000 (or 4% of the value of their investment in the farm). With a company tax rate of 28%, the farm's annual tax bill is $268,800.

The government bond rate (the risk-free rate which we use to define the minimum rate of return businesses should yield) is 5% say. In the case of Janet and John then their business already pays tax on 4/5 of the 5% deemed the minimum taxable return, so they would be liable for tax on an additional 1% or $240,000 of deemed earnings.

But remember the whole point of CCIT is to widen the tax base by closing the capital-based loophole, and by doing that, tax rates overall can be lowered. We estimate an overall increase in tax revenue of 20%, so that would enable a fall in the company tax rate from 28% to 22%. In the absence of the CCIT Janet and John face a tax rate of 28% (the company rate) and this is imposed on earnings of $960,000. After the CCIT is introduced, the tax rate could lowered (say to 22%) and, while their taxable income increases to $1.2m, their annual tax payment falls to $264,000 from $268,800.

If Janet and John's farm was earning say 10% on capital deployed, there would be no change in their taxable income under a CCIT-augmented regime and their tax load could fall substantially depending on how the proceeds from the CCIT translated into across-the-board tax cuts. The CCIT rewards profit-making firms.

The example illustrates the principles of CCIT.

(a) a fall in the tax rate is possible if the tax loopholes are closed off and the regime made fair
(b) businesses that fail to make even the risk-free return, face a rise in their tax burden. This either encourages such businesses to improve their efficiency or encourages their owners to exit, freeing up the assets for better management
(c) businesses making a return on assets at least as high as the risk free rate, will face no change in their taxable income, but will benefit from the fall in the tax rate

B 10: Are there overseas precedents for CCIT-type tax regimes?

The short answer is yes – there are regimes that tax property, regimes that tax wealth, and regimes that tax imputed income. For sure many aren't perfect, they are undermined by exemptions which enable the very rich to avoid them – such as not including the overseas assets of domestic taxpayers in their tax catchment – with the undesirable outcome that the tax burden falls primarily on the middle class. Another imperfection is that property values are not required to be kept up to date, meaning the effectiveness of such taxes has been undermined.

Staples and Simmons [2016] have carried out a comprehensive survey of the tax regimes that do include either wealth, property or imputed income.[17] The list of countries that do deploy such taxes is extensive and includes Australia, the UK, France, Belgium, Canada, Luxembourg, South Korea, Iceland, Switzerland, Denmark, the Netherlands and Germany. Many of these countries procure revenue from these taxes to an extent that the total revenue is at least 2% of GDP. Our estimates of what the CCIT would procure is between 3% and 4% of GDP.

Some countries struggle with defining the most appropriate deductible expenses. That reality makes the alternative of applying the CCIT only to the equity held in the asset (rather than the total asset value and allowing interest and other expenses deductible) more appealing. As well, the idea to apply the CCIT to the worldwide balance sheet of the taxpayer (rather than just the New Zealand assets) looks to be far more effective at preventing avoidance.

The Netherlands is closest to a pure CCIT regime – it uses a combination of a wealth tax and an imputed rental tax. Assets are assumed to have a 4% return, which is taxed at 30%. There is a per asset minimum of c.$NZ40,000 but no overall net asset minimum (debt is not taken into account).

C: Taxation of Foreign Entities

C 1: What's the Problem?

The tax base needs to be comprehensive if it is to be fair and efficient. A broad base enables rates to be kept as low as possible and, if there are no gaps in the tax base, decisions are made on the basis of economic return, not the incidence of tax.

Business income is part of the tax base and New Zealand is one of the few jurisdictions that operates imputation credits to ensure that the profits distributed to shareholders (not all profits are distributed) aren't taxed twice. Corporate tax provides 25% of the overall income tax revenue, PAYE provides 60%, and other personal income tax (for example earnings of the self-employed and term-deposit holders) provides 15%. So corporate tax is significant and protecting the integrity of the corporate tax base is important on both fairness and efficiency grounds.

Foreign-owned or partly foreign-owned firms operate in New Zealand and are expected to pay New Zealand tax on the profits they make here. If such firms were exempt income tax (paying tax only at home where tax rates may be lower) foreign firms would have an unfair tax advantage over domestic firms.

But clearly foreign-owned firms also pay income tax in their home tax jurisdiction. Double taxation agreements between countries have been developed to ensure that firms only pay tax on any particular dollar of profit once. Such firms are able to get a 'credit' from their home tax collector for the tax already paid overseas. But these double taxation arrangements only work if the tax regimes between countries are broadly similar – otherwise there is an opportunity for firms to arbitrage different tax regimes, meaning they would tend to gravitate their home office to the lowest tax rate jurisdiction they can find. Double taxation arrangements therefore are not universal – they only come about between jurisdictions of similar tax impost.

This 'ideal' cross border tax arrangement has over recent decades, come under duress, as countries have deployed all manner of means to provide lower effective tax rates to companies that base themselves in their jurisdiction. Their motive is to attract as much foreign direct investment (FDI) as they can. These measures extend far beyond the obvious 'weapon' of lower tax rates and include subsidies, tax exemptions, regulatory assistance, and other means which disguise the effective assistance being given. For multinational corporations there has evolved a 'game' wherein they have been inclined to hold auctions between countries for the privilege of hosting their head office – with the winner being the host with the most effective concessions.

Competition between countries to attract FDI has intensified over recent decades with countries like Ireland and Switzerland being the most aggressive with corporate tax rates of 12.5% and 8.5% respectively. In addition to lowering the corporate tax rate from 40%, Ireland also has allowed the "Double Irish" technique where a multinational would set up a subsidiary in Ireland, route profits from its other offshore operations to that subsidiary which would then, more via transfer pricing, transfer those to a second Irish subsidiary that had its headquarters in a tax haven. In 2014 the Irish government bowed to pressure from other countries and began phasing in a requirement that all companies in Ireland pay Irish tax (albeit at the low 12.5% rate).

However at the same time as Ireland's leaders announced the end of the "Double Irish" they introduced a new tax provision that allows companies to pay no tax on income derived from patents, licences and other intellectual property. So surprise, surprise – multinationals operating in other countries have subsidiaries in Ireland that hold IP and charge big fees to the company's subsidiaries in other countries – like in New Zealand.

In the face of this 'race to the bottom' in the taxation of multinationals, other countries have adopted aggressive tax regimes to attract foreign companies, albeit not via low headline rates. In the US for example the headline rate is 35% but the tax breaks are so extensive for corporates it ends up being much lower than that. The Netherlands and Luxemburg are also very active in this area.

The OECD estimates that anywhere between 4-10% of global corporate income tax revenue is being lost due to this unwarranted 'race to the bottom' for FDI.

These practices led to the establishment by the OECD in 2013 of BEPS – the Base Erosion and Profit Shifting project . This is an initiative aimed at producing a new international standard for the taxation of profits of foreign-owned firms. According to the OECD BEPS is aimed at "realign[ing] taxation with economic substance and value creation, while preventing double taxation". If something emerges from BEPS it will be the first substantial renovation of the international tax rules in almost a century.[18]

There is considerable argument over whether a collaborative approach as per the OECD's BEPS project will actually be effective in neutralising the taxation arbitrage that multinationals are conducting. Two countries in particular – Britain and Australia – have decided that the leakage is too significant to await international agreements. Their argument is that waiting for an internationally coordinated response is akin to the international efforts to get coordination on carbon emissions – struggling to move forward any faster than even a glacial pace. Meanwhile the multinationals are laughing and local firms in small, open economies like New Zealand are paying a high price. These firms operate under a competitive tax disadvantage that adversely affects employment and GDP. As well, New Zealanders miss out on the services higher tax revenues could provide or, alternatively, pay more in tax for existing services than they would otherwise.

Britain and Australia have moved to unilaterally impose their own tightening of rules around the conduct in their countries of foreign firms. There are risks of course of retaliation from other countries but presumably the rationale is that once an internationally coordinated effort is credible each country will join up. Meanwhile the damage must be halted.

The convention that has evolved over many decades is that income tax is liable in the country where a product or service is sold by the foreign firm. But a vexing issue arises - what are the appropriate costs to deduct from product sales in the jurisdiction in order to arrive at taxable profits? In New Zealand we have seen firms able to shift taxable profits beyond the New Zealand tax jurisdiction by claiming inflated costs - either interest payments incurred through taking on debt-heavy balance sheets (with the debt issued from related parties), or inflated ('transfer') pricing on their inputs (including IP, royalties, licences).

The challenge is how to address this tax arbitrage and bring to a halt the economic damage it imparts on countries where products are sold by foreign firms.

C 2: The Case for Unilateral Action

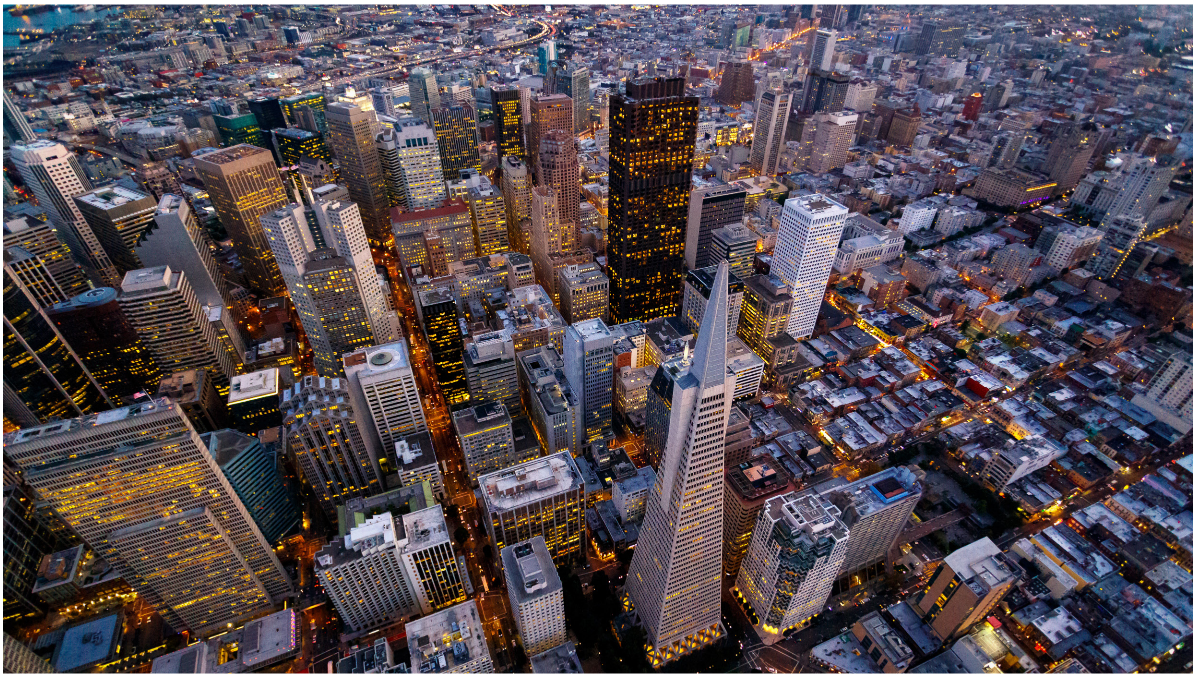
Given the scepticism that abounds around the OECD BEPS initiative, coupled with the economic damage being inflicted by the practices of the multinational corporations, how long should New Zealand allow the situation to persist? Should we just sit there and let the rorts continue until the OECD gets traction?

Tax professionals who earn fees from these aggressive corporate practices of avoidance may well say yes, harmonious treatment is vital. However there is considerable political opinion that such advice is sourced more in self-interest than in the national interest. I would suggest that New Zealand gets on with unilateral reforms, as the UK and Australia have done.

For credibility a tax regime must be seen to be fair; for efficiency it must be fair in reality. Having said that, it's a two way street and there are plenty of New Zealand firms generating income abroad who should also be subject to effective taxation policies in foreign jurisdictions. So we should be prepared for any change to our tax eligibility practices to be responded to – at least by mirroring - elsewhere.

One argument the tax advisory sector is promoting is that multinationals should pay tax only in their home country – this is where the capital (especially intellectual capital) is located.[19] But for the reasons outlined above if they face an easier tax burden in their home country, then they will be able to compete unfairly with local firms in higher tax jurisdictions. To the extent sales are made in the foreign market, the relevant costs associated with those sales should be deducted and the resulting profit taxed in the destination, rather than in the home country.

It is reminiscent of the historical arguments around 'dumping' – the business practice of selling products overseas at prices below those that apply in their home market. In dumping cases the strategy was to 'buy' foreign markets through the steep discounting, driving competitors out of business before raising prices to profit-maximising levels. In the case of tax arbitrage it is the home country's taxation system that is buying the foreign market for the firm.



Our morbid dependence on foreign direct investment (FDI) has become inculcated in the culture of the tax discussion in New Zealand. We see it here in film industry subsidies, we see it in continual warnings from the Treasury (our government's financial adviser) of "Armageddon" should these foreign corporates pay their fair share of tax. So long as New Zealand sacrifices fundamental principles around tax such as fairness, to this craving for foreign investment, while at the same time not ensuring capital deployed in our economy is used as efficiently as possible (the CCIT argument) then we will have an economy that is too dependent on the whims of multinationals. That is a feeble way to establish a society's economic base – making it so vulnerable to the behaviour of foreigners. Rather than continual banal calls for greater exports, Treasury would be more fruitfully employed looking at ways to reduce reliance on foreign capital.

The question is how does a country unilaterally deal to this rort between multinationals and the tax advisory industry? The UK has had enough, it is not going to wait for an OECD consensus and has chosen to bring in a "diverted profits" or "Google" tax.[20] This measure levies a 25% tax on profits deemed to be diverted out of the UK. Britain plans to accompany this measure by a 2% cut in the corporate tax rate to 18%. Australia has gone one better, levying a 40% tax on such attempts to divert profits.

The logical endpoint from failure on the part of tax authorities to ensure that foreign firms are on an equal footing with local firms is that local firms will relocate their head office overseas to enjoy the tax privileges afforded "foreign" companies. Even if these companies have no other sales apart from those in their home market, it can be worthwhile moving their headquarters abroad given the savings in tax. The US is battling this practice with several of its multinational corporates.

In aggregate, the amounts of assessable income being shifted are likely to be major and are just another demonstration that the biggest tax suckers in New Zealand are the taxed-at-source wage and salary earners (the equity argument) and that lost production opportunities for local firms ensue (the efficiency argument).

Unilateral action appeals because it brings this issue to a head sooner rather than later, possibly much later.

C 3: What Remedy could New Zealand Deploy Unilaterally?

In New Zealand foreign firms have a number of ways of avoiding the tax impost that they would face if they were New Zealand-owned. Some are due to regulatory weaknesses, others due to stratagems these firms employ to deliberately reduce taxable earnings. On the regulatory front there are weaknesses around the double taxation agreements that New Zealand is party to. In short they allow a foreign firm to avoid New Zealand income tax if it doesn't have a "permanent establishment" here.[21] For online businesses in particular this is a no-brainer. The remedy lies in modernising these tax treaties.

Given the two common ways for foreign firms to shift taxable profits beyond the New Zealand tax jurisdiction – namely taking on debt-heavy balance sheets, or deploying transfer pricing on their inputs – there are two broad ways to proceed.

The first is relatively simple but arguably overkill. It would see the IRD deeming a profit for the company as a pro rata share of the company's worldwide profit apportioned by its New Zealand share of global sales. Clearly for taxation purposes the "company" would need to be defined as the general group of companies behind the product or service, rather than any special purpose New Zealand subsidiary set up specifically for distribution here. That does give rise to identification issues and difficulties around partly foreign-owned local operations.

The second approach is to deal with the profit transferring behaviour of any foreign owned company operating in New Zealand. The remedies here comprise of two stratagems as follows;

1. Thin Capitalisation

Leveraging up the balance sheet so that interest costs rise is an easy way to dodge tax – the interest is a deduction and it flows offshore to who-knows-where so the lender (a related party) can collect that money in a lower (sometimes zero) tax jurisdiction. New Zealand moved against this in 1996 by introducing thin capitalisation rules which in effect nowadays attempt to limit the amount of gearing to 60% of the balance sheet assets of the New Zealand-registered company.

Of course this still affords plenty of scope for tax dodging via debt and seems little more than symbolic. A more robust way of setting the gearing ceiling would be to get data on industry average gearing for the firm's peers and set the ceiling at that level for all firms whose interest payments flow beyond our tax jurisdiction.

Our IRD would probably argue that would be too much hassle and that the 60% rule is quick and more-or-less effective. We'd suggest it's lazy and that the default should be no interest-bearing debt from abroad is allowed unless the taxpayer is able to prove their claim that the interest is a legitimate cost. They could do this only if the debt met particular criteria; for example to get tax relief the taxpayer would have to produce the data on international gearing norms for their sector and, secondly, provide evidence as to why their gearing internationally should be higher than international norms. With this sort of regime the onus of proof for deductibility lies with the taxpayer, not the IRD.

If they can't prove it they don't get it.

2. Transfer Pricing

The second tax dodge available for foreign companies is transfer pricing. Companies who play this game "purchase" an input from a related party that sits outside the New Zealand tax jurisdiction (often in a tax haven), effectively transferring their pre-tax profits to that party. Again the IRD does have a policy on this, it's a policy that reflects our signing of international double tax treaties with other OECD countries. But the reality is it doesn't work, we are sitting ducks. Multinationals can shift profits away from where the economic activity occurs to where the tax liability is minimised. Examples are abundant – Coca Cola, Facebook, Apple are just examples of multinationals operating in New Zealand whose practices have come under fire because their tax liabilities are significantly and consistently lower, year after year as a percentage of sales, than any comparable firms operating solely in New Zealand. Prima facie there is certainly a case to put the onus of proof of compliance on these firms.

In order to shut down transfer pricing practices firms should pass three eligibility tests before being allowed to claim the costs of imported inputs (materials, royalties, interest, licence fees) as deductible expenses. Importantly with these tests, the onus of proof for deductibility would fall on the taxpayer, and not be up to the IRD to prove an expense didn't qualify. If the corporate can't provide the proof then the costs simply are not deductible for the purposes of stating New Zealand taxable profits.

The first test for tax deductibility would be proving that the input being purchased from a non-New Zealand party is not from one that has a beneficial foreign shareholding of say 5% or more in common with the taxable company. 'Beneficial' covers direct and indirect (through third parties) shareholdings.

The second, and additional hurdle would be requiring the tax payer to establish that the cost of the input is no higher than would occur in an arms length transaction between non-related parties.

If the taxpayer cannot establish Test 2 because of lack of comparable industry data (such might be the case for a royalty for IP say) then the third test is for the taxpayer to establish that the royalty is no more than parties pay for the use of that IP in the IP owner's country. And if the IP owner's country is a tax haven then the taxpayer has to use as their benchmark the average of 3 white list countries to establish the absence of price-ramping.[22]

Finally, as an alternative to the eligibility tests above, the multinational could instead establish its taxpayer bona fides by simply proving that its overall tax burden across all the white list countries it operates in, is no lower than industry averages. This alternate method demonstrates that the New Zealand tax impost is intended to be no higher (or lower) than the average of white list jurisdictions.

C 4: Foreign ownership of residential property, land

With the exception of "sensitive land" New Zealand maintains an open borders approach to property investment by foreigners – no matter their origin. Such a strategy might make sense when it comes to commercial property - the origin of the investment doesn't matter if the result is higher utilisation of capital and greater income and employment. The CCIT discussed earlier would ensure that the stock of idle capital would be limited, no matter who the owner.

However when it comes to residential property in New Zealand there now appears to be a shortage of affordable property for prospective first-time homeowners. In Auckland, in particular, the price of housing appears to significantly exceed what would be justified solely by the demand for accommodation. It seems incongruous then that we allow foreigners (i.e. people who don't reside here) to hoard housing here for their own home-country reasons (for example, if their own country has poor enforcement of property rights).

It's especially unfathomable that we would exempt from reciprocal restrictions residents of countries that forbid ownership of residential property by New Zealanders. We surely should at least restrict them to leasehold ownership only. With the deregulation of Chinese capital now underway we can expect capital flight from that country, much as we see from Russia year after year. The sheer magnitude of the inflows could rise to levels quite disruptive, not just in the Auckland market, but countrywide. The rationale from these investors is simple – it's a bolthole in which to place savings beyond the reach of oppressive and unpredictable regimes in their home countries.

To welcome foreign investment is the hallmark of an open capitalist society, but when those flows come from residents of countries that lock out foreign investment as well as constrain the rights of their own citizens, that investment should be significantly qualified –

at least until the investor becomes a citizen of New Zealand or a similar “white list” country. The reason is not that we should not welcome foreign investment, but rather that the sheer magnitude of “bolt hole” capital flows can prove to swamp our small market with society-wide consequences. These flows come and go (remember the Japanese in the late 1980s, we thought they were going to annex Surfers Paradise at one stage?) and that instability is disruptive for our own residents.

Annexation of significant swathes of our property from local investors seems a senseless denial of local citizens’ access to their own productive capital – inhibiting employment and income growth.

In 2015 the UK followed the US, Switzerland, France and Spain by introducing a capital gains tax payable on sale by foreign owners of property. The rationale is that UK residents pay such a tax on their second and subsequent homes, and for foreigners this is an analogous situation. While a capital gains tax is nowhere near as efficient as a CCIT, the intention of these governments is clearly to limit the distortion of residential property markets caused by the activity of foreign buyers motivated by events in their home markets.

In New Zealand under a CCIT regime foreign investment in property would produce taxable income – the property would need to provide tax equivalent to a return on investment of 5% or the return calibrated in the income tax return, whichever is the higher.[23] The foreign investor would be subject to the normal provisions regarding tax deductibility of costs that are required of foreign investors.

The impact of this approach is to welcome foreign investment in non-residential property on the same basis as a New Zealand investor would encounter investing in a business. The effective restriction on foreigners would be with regard to investment in residential property which would be restricted to those from “white list” countries.

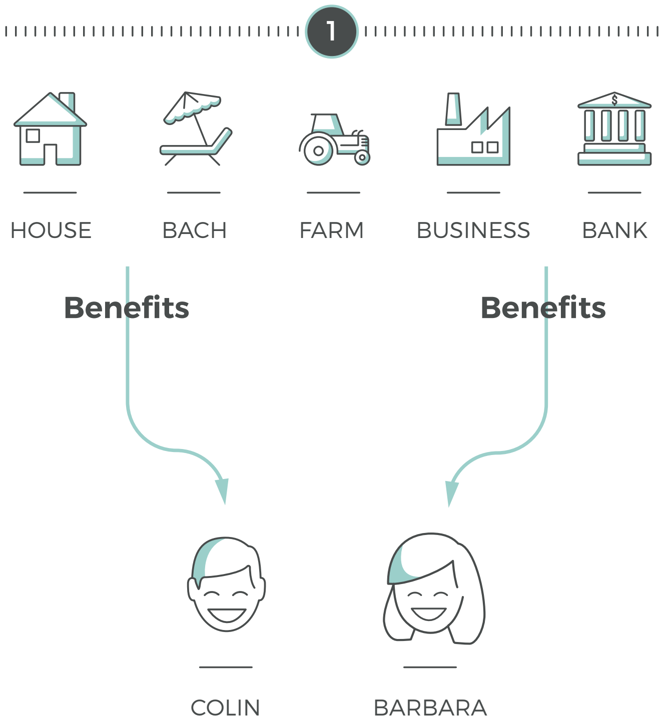
D: Conclusion

This paper has covered just two of the weaknesses in our taxation regime that are underwriting an unfair and economically inefficient economy. The costs of conferring privilege are real – not just financial – but more widely than that socially and politically. It is incumbent on a government to continually strive to maximise the performance of its taxation regime on the basis of neutrality, equity and efficiency.

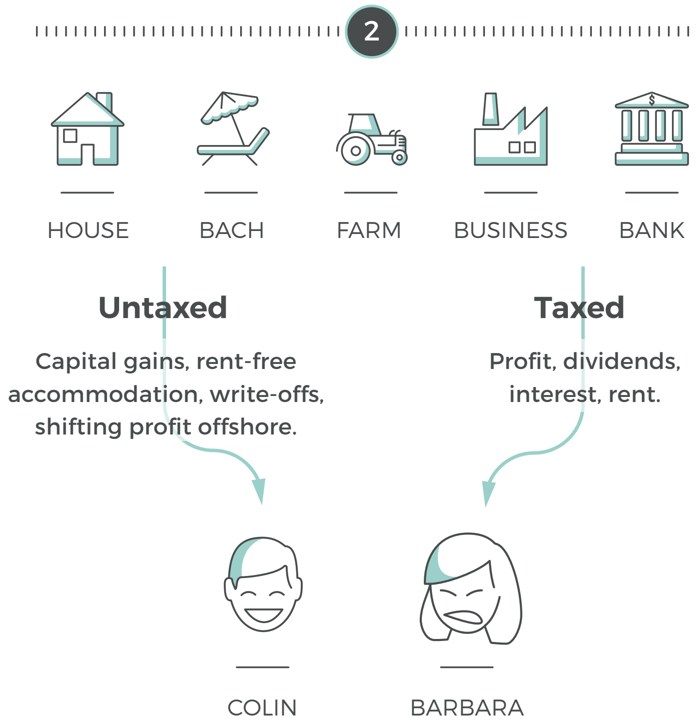
Several of our taxation structures are able to be exploited and that is exacerbating inequality across society as well as denying New Zealand the economic growth is could otherwise achieve. A growing problem is the tyranny or hegemony of the majority wherein a substantial tract of voters – the property-owning group – is able to extract benefit for no value provided to society. Such rent-seeking is the antithesis of an efficient, equitable society and warrants corrective measures.

The two topics covered in this discussion on tax are by no means an exhaustive canvas of what can be done to improve our taxation regime. There are issues around tax and charitable organisations and around tax and the Approved Issuer Levy available to those raising money from abroad, which also warrant examination. They, amongst, others will be the subject of future work.

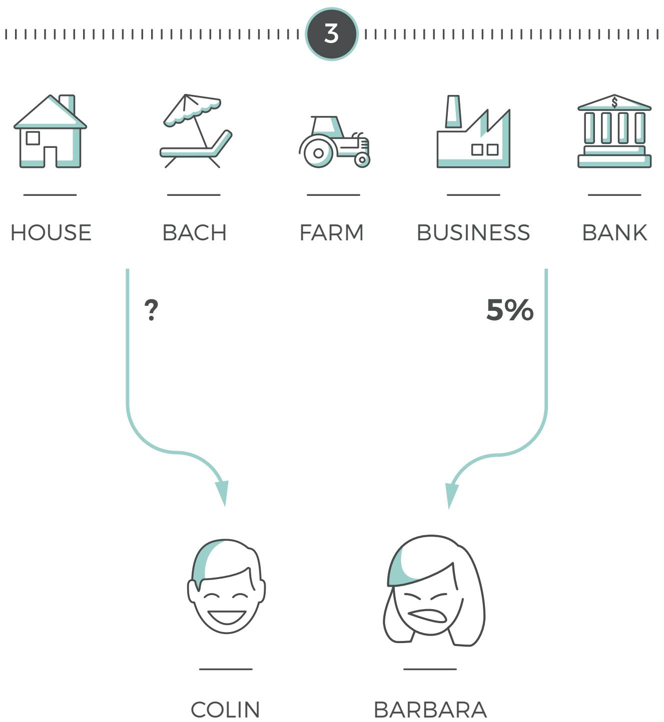
How Does the CCIT Work?



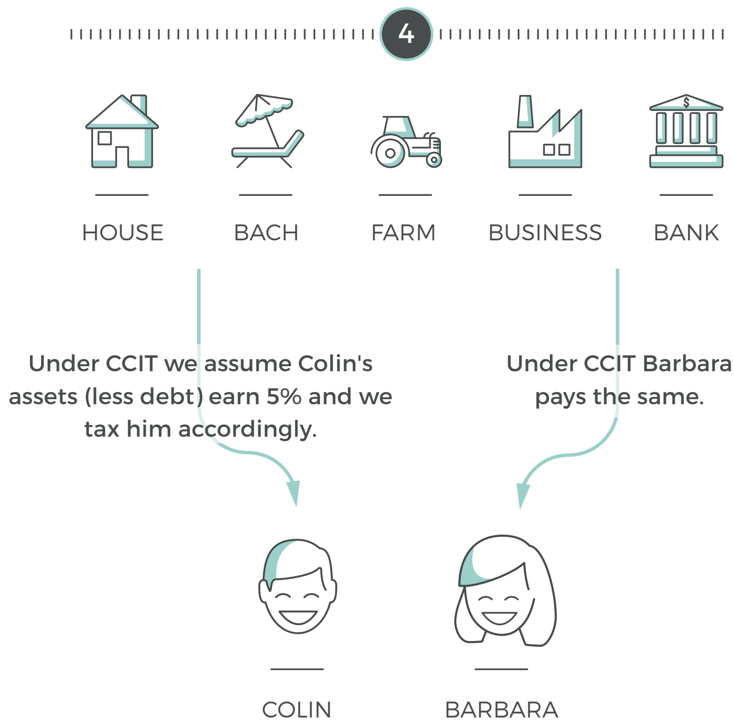
Colin and Barbara both own assets. They both enjoy benefits from owning those assets.



Some of those benefits are taxed and some are not. **THAT IS UNFAIR!**



For 20 years Barbara has got 5% return on government bonds at no risk.
Why is Colin investing for a lower return?
He must be making an untaxed return.



CCIT applies to **ALL** major assets & **ALL** taxpayers. Revenue can be used to reduce income tax so majority better off.

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