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THE PATH TO PERSONAL TAX REFORM

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The path to personal tax reform

The long term policy options to achieve personal tax reform

- *New Zealand's position relative to other countries (particularly Australia)*
- *How to bridge the gap between personal incomes in Australia and New Zealand*
- *Achieving progressively lower rates of personal taxation while avoiding adverse impacts on inflation and interest rates*

PERSONAL INCOME TAX RATES

1. General

- As much to do with politics (philosophical position) as it is with economics
- Was a material discussion point at the last election and likely to be the same at the next election

2. Need to be put into context

- Trust rate 33%, corporate rate 30%, savings vehicles 30% and highest marginal tax rate 39%
- Needs to be part of a destination of reform regarding rates

3. Relevance of personal tax rates

- Personal tax comprises 15% of GDP – ie large, it represents \$26b out of a tax take of \$55b. This \$26b ignores “personal” income retained in Trusts and companies.
- Equity issues in terms of regulatory arbitrage / compliance costs associated with securing and policing the boundary – exacerbated with the recent changes around the taxation of collective investment vehicle
- Major part of:
 - The overall structure of Government transfers from and to citizens
 - The incentives to return to work, stay at work and working harder to earn more
- Some of these concerns have already been highlighted by officials in their briefing papers to the then incoming Government released in September 2005

4. Certain issues with the existing marginal tax rates particularly the 39% rate

- Compliance issues; multiple rates mean:
 - More complicated regimes with final tax, e.g. FBT, SSCWT, setting the trust rate etc
 - Incentives to structure - either complicate tax system to address or accept equity problems
 - Wasted costs in economic terms, e.g. costs to establish trusts and companies (legal, accounting and advisory), costs of ongoing administration, costs of regulatory compliance such as Companies Office returns, tax returns, etc.
 - Complexity in terms of legislation to strengthen 39 per cent tax bracket e.g. income attribution rules, trust distribution rules, etc
 - Complexity in dealing with the Inland Revenue e.g. what is the tax avoidance boundary

- Bracket creep:
 - 2000 5% of the population were subject to the 39% rate
 - 2007 14% of the population were subject to the 39% rate (artificially lowered because of structuring out) e.g. level of earners at \$60,000 spiked when the rate was introduced
 - Impacts a greater proportion of blue collar workers – 75% of all secondary teachers
 - Impacts a greater number of people who want to increase income etc.

- Equity:
 - 39% is not the bastion of the most well off but those that can not structure outside earning income directly
 - Employees and to some extent the self employed are subject to the 39% tax rate
 - Many self employed, e.g. builders, plumbers, electricians, farmers, small/medium businesses can and do structure out of this tax; e.g. a self employed businesses person and an employee can earn exactly the same income yet face different tax rates.
 - Compare income splitting at its maximum:
 - Employee earning \$100,000 pays \$30,270 in tax
 - Self employed who can justify paying \$38,000 to a spouse and uses a trust can reduce this tax to \$22,740
 - The \$,7,530 represents a 24.8% reduction in taxes
 - Maximising the 19.5% tax bracket, the self employed person will also have “income” for family assistance purposes of only \$76,000 whereas the employee has income to \$100,000.
 - PIEs have exacerbated the equity issues.
 - A person earning \$100,000 investment income pays \$30,270 in tax, as above.
 - A person earning the same amount but by investing through a PIE and Trusts can pay only \$24,900.
 - The \$5,350 represents a 17.7% reduction.
 - If the person has a spouse, the entire \$100,000 can be structured so that it is subject only to 19.5% tax, a savings of \$10,770 or 35% reduction
 - Conversely, many businesses can not structure profits through trusts and companies. From 1 April 2008 many businesses will only pay 30% tax, yet some will still pay 39%; there is no equity in this.
 - SSCWT has allowed individuals on wages/salaries to obtain a tax reduction if they invest into a Kiwisaver fund, effectively a salary sacrifice of an equivalent 4% of gross income can be made to a Kiwisaver account with no tax. An individual on \$100,000 can effectively make a contribution of 4% and save \$1,500 tax. This is a 5% reduction of tax compared with a self employed person who can obtain NO tax relief from contributions to Kiwisaver accounts.

- International comparability in terms of recruiting internationally, returning expatriates etc:
 - Australia 45% @ AU\$150,000 pa (to rise to AU\$180,000 pa)
 - US 35% @ US\$349,700 pa (single)
 - UK 40% @ £34,600 pa
 - Canada 29% @ C\$120,887 pa (excluding provincial taxes)
 - Ireland 41% @ €34,000 pa (single without children)
 - New Zealand 39% @ NZ\$60,000

5. Why the comparison with Australia is important

- Closest economic partner / competitor
- Most substitutable labour market - mobility
- Rightly or wrongly, we are compared with Australia – see R&D reaction
- Comparability is fraught with difficulties including exchange rates, tax preferences (working for families), other taxes and the scope of taxes, but as set out below the wedge is material in absolute and relative terms

Income	New Zealand Tax 07	Australian Tax 07	Australian Tax 08	Tax Wedge 07	Tax Wedge 08
20,000	3,629.79	2,100	2,100	1,530	1,530
30,000	5,729.79	3,600	3,600	2,130	2,130
40,000	8,069.46	6,600	6,600	1,470	1,470
50,000	11,369.46	9,600	9,600	1,770	1,770
60,000	14,669.46	12,600	12,600	2,070	2,070
80,000	22,469.07	19,099	18,600	3,370	3,870
100,000	30,269.07	27,099	26,599	3,170	3,670
140,000	45,869.07	43,099	42,599	2,770	3,270
180,000	61,469.07	60,599	58,599	870	2,870
200,000	69,269.07	69,599	67,599	(330)	1,670
240,000	84,869.07	87,598.70	85,598.70	(2,730)	(730)

- The clear perception is that Australia taxes less across the board – comment in the most recent NBR Rich List supplement:

“New Zealand’s tax laws and Australia’s tax laws are going in different directions...Capital will flow to where it gets the best return. People are going to find it easier to get ahead in Australia.”

Perception becomes reality

- Exacerbating the issue is comparability of real incomes / opportunities

6. What should any Government's overall strategy / goal be?

- Attract and retain capital / economic activity within New Zealand consistent with recent initiatives around:
 - Transitional residents relief for 48 months
 - Corporate tax rate reduction to 30%
 - Introduction of an R&D regime
 - Numerous savings initiatives
- Set a destination of rate reform - plan to get there – no big bang but incremental process
 - Ultimate destination of reform should be no / minimal regulatory arbitrage
 - Impact on inflation and interest rates are not perfectly correlated and can be mitigated by incremental change
- Perceptions are important:
 - Headline rates “get the headlines”
 - Sets the scene: as a nation is NZ friendly towards wealth creators / those that are looking to get ahead?
- “Best world” system – what is it?
 - Philosophical underpinning (redistribution?)
 - Economic underpinning (encourage innovation and economic growth?)
 - **Ultimately it would entail a broad base low rate**
 - **Correlation to savings - probably**

Our view of the medium term goal for tax rates should be:

OPTION ONE

Tax category / bracket	Rate	Estimated fiscal cost pa
Corporate rate	28%	+\$360m
Individuals:		
Top individual tax rate (currently 39%)	28%	\$1.6b
Middle tax rate (currently 33%)	28%	\$0.6b
Low tax rate (currently 19.5%)	19.5%	n/a

- A sub 30% goal is making a real statement in terms of attractiveness as a jurisdiction
- Having a destination of reform does not require that the initial step be to that destination.
- Timeframe for the above, as soon as practicable noting the need to control inflation and interest rates.
- If an interim step of having a 30% common rate, then the fiscal cost would be as follows:

OPTION TWO

Tax category / bracket	Rate	Estimated fiscal cost pa
Corporate rate	30%	
Individuals:		
Top individual tax rate (currently 39%)	30%	\$1.3b
Middle tax rate (currently 33%)	30%	\$0.4b
Low tax rate (currently 19.5%)	19.5%	n/a

- Signalled that '08 budget will signal strategy long term re tax rates – too late or simply reality as part of the political cycle?
- Other material matters in train include:
 - International tax review – e.g. active income exemption and NRWT reductions
 - Imputation review including the use of imputation credits