

**INVESTMENT SAVINGS & INSURANCE ASSOCIATION OF NZ
INC**

Submission

to

The Centre for Accounting,
Governance and Taxation
Research - VUW Tax Working
Group

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1 Introduction

In a recent speech, the Minister of Revenue outlined the Government's key tax policy objectives as:

1. Better positioning New Zealand in the world economy.
2. Responding effectively to the changing economic and fiscal environment.
3. Maintaining tax revenue.
4. Improving tax administrative systems, so that they can operate more effectively and deliver greater value for money.

Within this framework, the Government's medium term objective is alignment of company, trust and personal tax rates at 30% (the so-called "30/30/30" option). In turn, the Victoria University Tax Working Group (the "Tax Working Group") has been set up to:

...test these medium-long term objectives and endeavour to ensure there is broad understanding of what are likely to be seen as key pros and cons of different possible ways of reforming taxes in the medium term and of raising additional revenue to fund suggested tax rate cuts or other changes to the tax system.¹

The Investment, Savings and Insurance Association of New Zealand (the "ISI") believes the taxation of savings forms an important part of the overall puzzle. Our submission is framed around delivering the best opportunities for New Zealand.

The Tax Working Group has a wide range of fiscal matters to consider in any recommendations it makes. These include the need to develop the productiveness of New Zealand's economy, the need to retain a larger proportion of New Zealand's skilled workforce within New Zealand and the need to reduce New Zealand's reliance on foreign capital and investment.

However, as any reforms undertaken will be required to be revenue neutral, careful consideration will need to be given to their impact on the ability of the Government to facilitate its future spending programs. One of the main constraints to development in these areas over the long term is likely to be in the form of increases in Government expenditure and reduction in Government revenue as a result of New Zealand's ageing population.

The ISI considers that ultimately all these factors lead to a consideration of New Zealand savings. Accordingly, we consider that the Tax Working Group must have significant regard to the impact on savings of the recommendations it makes.

Overall, New Zealand's broad based tax system compares well internationally. In general terms, simple rules with broad application have been the preferred policy position for understandable reasons. For example, the limited exemptions to our GST mean that it is well understood, compliance appears to be high and there are not the same issues and avoidance opportunities as in other jurisdictions with complicated exemptions.

¹ VUW Tax Working Group Scope and Objectives

However, the current tax framework does not produce consistent results across all forms of investment. As a result, certain investments such as residential housing receives disproportionate investment, partly based on tax considerations, rather than investment being made where it can be most productively employed.

On the basis of both research and the experience of foreign jurisdictions, we consider that the introduction of reforms to both encourage greater savings and provide a “level playing field” for investments will encourage diversification of risk by individual investors resulting in better returns and provide social and fiscal benefits for the New Zealand economy over the long term.

Dr Ken Henry’s 1 October 2009 Address to the Australian Conference of Economists Business Symposium summarised the Australian position thus:

We have a system for taxing personal capital income that has evolved into something that is, to put it mildly, far from the originally intended ideal.

Further, the case for staying true to that original ideal now appears weak; while the case for moving to the other conceptual ideal is not strong either.

Meanwhile, we have a tax system for household saving that has not been calibrated to address the challenges of population ageing and the financing of unprecedented levels of business investment and infrastructure.

While we can see that we have a system that is ripe for reform, we can also see a complex set of tradeoffs in respect of the choice of the savings base, the choice of rate and the forms in which such a tax might be levied. Judgement is required.

ISI’s submission is consistent with this questioning of the current norms for the taxation of savings.

1.1 About the ISI

The ISI has 20 investment and life insurance members and 19 associate members. The ISI represents investment and life insurance companies in New Zealand. Member companies manage over \$50 billion in savings and provide other financial services on behalf of more than 1,500,000 New Zealand investors and policyholders.

One of the key objectives of the ISI is to work to secure the future of New Zealanders. It does not just represent the interests of its member companies, but works to ensure that New Zealanders are provided with the best options to secure their own future through savings, investment and the protection they receive from insurance.

2 Saving for retirement

The increased costs associated with an ageing population are well known. Recent forecasts predict that over the next fifty years the proportion of people in New Zealand over the age of 65 will more than double, from 12 percent in 1999 to 26 percent in 2050². These increases are expected to have a significant impact on both Government revenue and spending programmes (particularly health spending) in the future.

To help combat the financial pressure of this potential decline in future revenue and increase in future spending, the New Zealand Superannuation Fund was introduced in October 2001. The aim of this fund was to partially pre-fund this future expenditure now in order to smooth the cost of future Government spending over a longer period of time. New Zealand Superannuation has significant benefits in terms of its simplicity (it is universal and non-means tested) and its ability to alleviate the financial burden on those with low levels of personal savings.

Following the same principles, private retirement savings provides individuals with the opportunity to pre-fund their own future expenditure throughout their working lives. Private retirement planning has the added benefits of providing the individual with greater self reliance and flexibility in when and how they will transition into retirement.

2.1 The wider social and fiscal benefits

In addition to the benefits which retirement savings provides the individual retiree and their families, there is a large body of research and evidence to suggest that increased levels of savings in general provides a wide range of greater social and fiscal benefits over the long term (or “externalities” in economic jargon). Recent research undertaken by the New Zealand Treasury³ suggests that a sustained increase in national savings could significantly enlarge and deepen the New Zealand financial system with knock-on effects for firm growth and productivity.

This is supported by the international experience of countries such as Australia and Chile where long term increases in national savings levels have led to a more robust financial system and sustained economic growth.

The Australian superannuation industry has over A\$1 trillion in assets under management, providing a significant pool of capital to Australian (and New Zealand) businesses. In contrast the market capitalisation of the New Zealand stock exchange is around NZ\$50b, whereas the stock of residential property is approximately ten times this.

Based on the evidence above and the experience of the ISI, increasing the level of savings by New Zealand households should be encouraged. However, as the choice to save will often come at the expense of an individual’s current living standards, some balance will always need to be achieved between meeting the requirements of the present and those of the future.

² Stephenson, J & Scobie, G (2002) “The Economics of Population Ageing”, Treasury Working Paper 02/05

³ Cameron, L, Chapple, B, Davis, N, Kousis, A & Lewis, G (2007) “New Zealand Financial Markets, Saving and Investment”, Treasury Policy Perspectives Paper 07/01

2.2 New Zealand's saving record

Based on an analysis of the market, New Zealand currently has a low level of “national savings”⁴ (savings by households, businesses and Government collectively) compared with other countries in the OECD. Evidence also suggests that this level of savings is on the decline. Whereas Government savings have appeared strong over the recent past (as evidenced by recent Government surpluses), household savings have been reported as very low and in some cases negative⁵.

New Zealand's savings deficit has contributed to our consistent net balance of payments deficits, the net external indebtedness and a high reliance on foreign savings⁶. The flow on effects of this are a high level of foreign ownership of assets and a higher risk premium on New Zealand investments (reflected by relatively high interest rates by world standards, and consequently high exchange rates as foreign investors increasingly look at high yielding foreign currencies like the NZD). The result is a high cost of capital for New Zealand firms and shallow capital markets due to a lack of domestic capital to fund New Zealand businesses.

This is expressed in a comparison between New Zealand's Gross Domestic Product (GDP) and its Gross National Income (GNI). The wide gap between these two measures is evidence that overall a large proportion of the income from which New Zealanders produce as a nation is going offshore.

Combined, these factors indicate that New Zealanders have too low a level of national savings and, as a result, do not currently enjoy the full benefits of what they produce.

We do not believe that the Government sponsored superannuation will be enough to facilitate the high living standards New Zealanders will expect during retirement, particularly as contributions to the New Zealand Superannuation Fund have been suspended for the foreseeable future. The key change has been the Government's fiscal position, going from a surplus of around \$2.5 billion in 2008 to a deficit of over \$10 billion in 2009. Going forward Government is expected to be a net borrower to the tune of around \$250 million a week.

This puts the onus on private retirement savings to bridge the income gap during retirement.

A recent Government focus on encouraging national savings has resulted in the introduction of KiwiSaver and portfolio investment entities, introduction of the Retirement Commission's financial education campaign and a regulatory review of financial products and providers⁷. These initiatives have been widely seen as positive moves towards encouraging individuals to save.

⁴ Supra note 3

⁵ Hodgetts, B Briggs, P & Smith, M (2006) “Household Savings and Wealth”, Economics Department, Reserve Bank of New Zealand, Wellington

⁶ Supra note 3

⁷ Whitehead, J (2007) “Treasury Report: A Synopsis of Theory, Evidence and Recent Treasury Analysis on Saving” Report: T2007/654

2.3 Development of New Zealand's financial system

As important a consideration as the quantity of New Zealand's savings is the quality of New Zealand's savings.

Along with a comparatively low level of national savings, New Zealand also has a disproportionate amount invested in lower productivity investments. As a result, with the exception of New Zealand's banking system, many areas of the financial markets (such as equity, venture capital and debt markets) remain relatively under-developed. This is due mainly to both this low level of national savings but also to a relatively high cost of capital. There is significant research and evidence to suggest that this under-development is creating a constraint on the growth and performance of the New Zealand economy.

The strength of New Zealand's banking system, places New Zealand's banks as the single largest direct provider of debt finance. As recent experience has shown, the banks themselves rely on the provision of credit from foreign rather than New Zealand savers to finance their lending. In comparison, markets for additional equity and other forms of finance are small and lacking in depth and liquidity. As a result, New Zealand companies have very little alternative when it comes to arranging finance and this has resulted in an increasing dependency on ultimately foreign sourced investment and savings.

Another feature of New Zealand's financial system is a disproportionate investment in the residential housing sector (especially by individuals). Along with other socio-economic factors, this behaviour is currently encouraged through a comparatively favourable tax system on housing income.

The dominance of residential property in New Zealand households' balance sheets has resulted in less domestic capital being available to invest in New Zealand businesses. The gap is currently being filled by foreign lenders and equity. The New Zealand managed funds sector, as noted in the Treasury's research, provides an important alternative to foreign ownership of assets.

This bias towards a small number of sectors discourages competition and diversification of investment increasing the cost of capital. This in turn hampers growth opportunities of New Zealand companies.

We consider that an increase in the level of national savings and a focus on the development of New Zealand's financial system (in particular the encouragement of institutional investors such as superannuation funds) is likely to create a number of benefits to the economy such as:

- Development of greater financial literacy amongst investors and a framework that favours the accumulation of long-term capital;
- Fostering of competition for savings thereby lowering management fees and the cost of capital;
- Promotion of financial innovation creating new securities and products in order to diversify portfolio risks;

- Promotion of greater market discipline and stronger corporate governance through investor demands for greater transparency and accountability.
- An increase in domestic investment and New Zealand ownership of New Zealand based firms, helping address concerns around “hollowing out”;
- Greater portfolio diversification through increased ownership of offshore assets;
- A potential reduction in the current account deficit and the exchange rate benefitting exporters;
- A reduction over time in New Zealand’s external liabilities, reducing New Zealand’s risk premium and reducing credit supply risk in difficult financial times (i.e. where investors demonstrate home country bias). Overall this results in a reduction in the cost of capital; and
- A reduction in the tendency of the housing market to overheat and create excess demand and rising debt in the economy.

The Australian experience is instructive. Following the introduction of its compulsory superannuation regime, the increase in national investment in superannuation funds has led directly to some concrete benefits to Australia’s wider economy. These include the evolution of new and innovative investment classes, an increase in financial literacy amongst savers, the development of a robust regulatory environment and overall sustained economic growth. This has been most recently evidenced by the comparative success with which Australian firms have been able to re-capitalise in the recent financial down-turn.⁸ The increase of investment into more productive types of investment by definition means that those funds are being used more productively in the economy.

Increasing savings would have flow on effects throughout New Zealand’s economy affecting not only returns on savings, but also the development of greater and more diverse sources of New Zealand capital and the creation of jobs.

These conclusions are also supported by a recent Treasury Policy Perspectives paper⁹ which reports that the development of these under-developed areas of our financial system is likely to directly result in increases in the performance of New Zealand’s economy in a similar manner to Australia’s experience.

As such, in order to provide the greatest benefit to New Zealand’s economy, any programme designed to increase the quantity of national savings must also look to increase the quality of savings through the development of New Zealand’s financial system.

⁸ Bowen, Hon Chris, (2009) “Launch of ASFA’s better living standards and a stronger economy: the role of superannuation in Australia’ report”, Speech, 21 October 2009

⁹ Supra note 3 at page 16

As it plays an important part in the decision making process, any policy designed to diversify and develop the financial market will need to consider the impact that taxation has on investment decisions.

2.4 Summary

The reliance on residential property investment is not desirable from a macroeconomic risk perspective as Zealand's economic performance is highly correlated with the New Zealand housing market; nor does it make good sense from a household risk diversification perspective to have very little exposure to financial assets, other than bank accounts.

Any tax reform undertaken should focus on encouraging both an increase in the level of national savings and a diversification of investment. The encouragement of this behaviour will have the effect of not only developing under-developed sectors of New Zealand's financial system, but also result in significant wider social and fiscal benefits to New Zealand's economy.

However, tax incentives should not be viewed as the sole influence on investment decisions and there is an important role for the investment industry to play in this regard. Members of the ISI in particular have a role in marketing their investments to focus on the benefits of their investments including a reduction of risk through investment diversification and fund manager expertise. Most importantly, in order to compete with the perceptions of other investments such as residential housing, this focus needs to be on the greater long term gains to be had from such investments.

We consider the current taxation of investments and potential reforms in further detail below.

3 The taxation of savings

Broadly, New Zealand has traditionally followed a “TTE” (Tax-Tax-Exempt) approach to the taxation of savings. Namely, savings are generally funded out of post tax income (T), returns on savings are taxed (T) and withdrawals of savings are tax-free (E). The policy underpinning this treatment has been to apply a neutral treatment across the different forms of savings and to tax income from savings identically to other forms of income such as business income¹⁰.

However, recent research into the make up of New Zealand’s taxation system has shown that this approach is not applied across the board to all sources and methods of savings income creating distortions in investment decisions¹¹.

3.1 Direct versus indirect investment

Where an individual invests through a collective investment vehicle (such as a unit trust or superannuation fund), it will generally be the intermediary’s business practices which will determine whether gains from an investment are taxable income for tax purposes. However, were the individual to undertake the investment themselves it will often produce a better tax result. This creates a distortion away from the use of intermediaries by lenders/savers and toward investments made directly, or structured in such a way as to appear to be direct¹².

The benefits of investing through collective investment vehicles over direct investment are well known. This includes the ability of investors to reduce risk by taking a share in a diversified investment portfolio and benefit from the expertise of professional investment managers to gain a better return. Accordingly, the need to counter this disparity between the taxation of direct versus indirect investment was a driving force behind the introduction of the portfolio investment entity (“PIE”) regime.

The PIE rules were introduced as part of the KiwiSaver initiative to encourage (or at least not discourage) an increase in savings through managed funds. The rules included an exemption from tax on gains in certain Australasian equity investments to mimic the result which direct investment might produce. To encourage a greater level of investment, the rate of tax on investments in PIEs was aligned with individual marginal tax rates capped at 33% (now 30%) providing a perceived saving to those on the higher individual marginal tax rates. In addition, the PIE income is excluded from an individual’s taxable income meaning it does not impact transfer payments and certain social assistance regimes. These changes have been widely seen as a positive development encouraging an increased level of national savings and reducing the bias between individual and direct investment in a large number of investments.

However, outside the PIE rules, there is still a large disparity between the taxation of direct and indirect investments. This is especially true in respect of the application of the distinction between capital and revenue property where the operations of the intermediary (e.g. a company) can produce a different result to what an investor in their own name would face. This is discussed in further detail below in respect of investment in residential housing.

¹⁰ Treasury (June 2001) “Executive Summary – Issues Paper – Tax Review 2001”

¹¹ Supra, note 3

¹² Claus, I, Jacobsen, V and Jera, B (2004) “Financial systems and economic growth: An evaluation framework for policy” New Zealand Treasury working paper: 04/17

3.2 Investment in residential property

As discussed above, a large proportion of New Zealand household savings are invested in residential housing. Whereas the OECD average is less than 50%, New Zealand households currently hold over 70% of their assets in some form of residential property¹³.

Although there are a large number of considerations governing investment decisions, the comparative taxation of income from different investments is likely to have a significant impact on these decisions. In particular, with residential property, the relative light taxation of such investments.

The popular mis-conception is that New Zealand does not have any capital gains taxes. However, in practice a significant amount of capital gains in New Zealand are effectively classified as taxable income through the operation of tax legislation. Accordingly, as increases in the value of residential housing are generally treated as tax-free to household investors, this represents a significant tax advantage for investors (i.e. the difference between tax at 0% and 38% – the top marginal tax rate). In contrast, investments in shares are comprehensively taxed, via the company tax base (i.e. the underlying earnings are taxed as they accrue, and this should be reflected in a lower company share price).

In addition to this benefit, the availability of tax deductions for depreciation and the ability to negatively gear residential properties has resulted in a large percentage of New Zealand's investment base (over \$200 billion in assets) generating negative taxable income (losses). In essence the Government is paying out refunds on these investments notwithstanding the investments are generally cash-flow and return positive (i.e. once the capital gain is also taken into account).

There is evidence to support that this treatment of home ownership encourages distortions in the investment behaviour of savers at the expense of other types of investment.

¹³Supra, note 10

4 Where to from here?

As outlined above, tax is one of several factors which will influence people's savings decisions; both how much they will save and the form in which they will save¹⁴. Given the aforementioned benefits which are likely to flow from both an increase in national savings and development of under-developed sectors of New Zealand's financial system, any policy change will need to focus on both encouraging further investment and further diversification of investment such that funds are able to be allocated to their most productive use (not the most productive tax use).

4.1 Increasing national savings

4.1.1 Non-tax drivers

We outline below some of the non-tax options, which may be complementary to any tax reform.

The introduction of KiwiSaver has been a positive step towards improving the level of New Zealand's national savings. However, in its current format, it is questionable whether it will deliver the increase in national savings required to meet the future demand of New Zealand's ageing population.

The experience of countries such as Australia and Chile shows that a sustained increase in the level of national savings can have a positive impact on both the country's current financial systems and their ability to meet their future expenditure. Accordingly, in order to achieve these benefits further or stronger pro-saving action is now justified¹⁵.

An important consideration in any reform is the recent agreement between New Zealand and Australia in respect of transfers of retirement saving between certain Australian superannuation funds and New Zealand KiwiSaver funds. The closer our superannuation systems and investment taxation rules are aligned, the easier and more broadly such a transfer system is likely to operate. Any perceived tax disadvantage will reduce the prospects for the savings to migrate to New Zealand.

One policy option often debated is whether New Zealand should introduce some form of compulsory superannuation savings. Although KiwiSaver introduced a level of "soft compulsion" towards superannuation savings, it stops short of requiring individual savers to save. Investors are also able to take indefinite "contribution holidays", which is also likely to impact the level of savings over the long term. The introduction of compulsory superannuation savings in Australia has seen a sustained increase in the level of national savings and a strengthening of the Australian economy as a whole.

In the New Zealand environment, the introduction of compulsory superannuation would help accelerate the investment needed to develop the financial system. However, if such a reform were not desirable, an alternative method would be to require some greater form of "lock in" of savings. Requiring this focus on long term investment would have benefits both in the ability of

¹⁴ Supra, note 10

¹⁵ Supra, note 7 at page 4

the investments to provide long-term returns to savers and in maintaining a higher level of national savings overall.

In the event that compulsory superannuation or some greater level of investor “lock in” were to be introduced, careful consideration would need to be applied to the rate of taxation and levels of contribution required from individuals.

4.1.2 Tax drivers

Our experience is the tax system does drive behaviour. For example, in overseas jurisdictions taxpayers will look to make end-of-year decisions based on the tax incentives available. Where savings investments are tax favoured, they will capture the taxpayer’s dollar.

No single tax reform should be viewed in isolation and care should be taken to evaluate the impact on the ability of individuals to save as the result of other potential policy changes such as changes to the rate of GST or personal income tax rates.

New Zealand stands out in not comprehensively reducing or deferring taxation on savings, particularly retirement savings. The taxation of savings at marginal taxation rates has been (and to a large extent still is) the normative policy position in New Zealand.

In the Tax Working Group background papers released to date, there is virtually no discussion of the disincentive effects of a 38%, 33% or even 30% tax rates on the return to savings, particularly long-term savings and the risk/return trade-off. The ISI believes that this is an area that requires careful consideration.

Australia’s retirement savings model contains significant tax benefits, including a 15% tax rate on retirement savings in managed funds. This compares with 30% under the PIE rules. In the context of Trans-Tasman superannuation portability, it begs the question why New Zealanders with Australian superannuation savings would ever choose to transfer their savings to New Zealand, with the current tax disincentives.

What is the appropriate rate to tax the return to capital? Other countries have answered this implicitly through deferring tax on retirement savings and lower company tax rates. It is well established economic theory that taxing capital at high rates is distortionary, much more so than say directly taxing labour (which will end up bearing the tax burden in any event).

There is therefore strong support for lowering the tax rate on capital (and we note the Government has signalled changes in this general direction already (e.g. the proposed Approved Issuer Levy changes)) recognising the importance of reducing the cost of capital for New Zealand firms.

From a broader perspective, a current disincentive to savings in New Zealand is the focus on taxing income from savings now rather than deferring tax until the revenue earned aligns with the future expenditure it is designed to offset. The effect of this approach is to inflate Government revenue now at the expense of a balanced inter-temporal view of Government expenditure. Unlike the approach of many overseas jurisdictions where savings revenue is matched against future expenditure, this current approach taxes the inflation component of long

term investment and makes other options such as investment in residential housing comparatively more attractive.

Taxing the inflation component of long-term savings is a major concern. Given the long-run nature of retirement savings, inflationary gains could make up a significant component of the return to savings (much more so than taxing, say, current nominal employment earnings). Taxing this return on retirement savings (particularly when other investments face a lower or no tax liability on inflationary gains) shifts the playing field in favour of these lower taxed investments. This is not a desirable outcome.

We believe that the deferral of taxation on savings until retirement aligns taxation revenue with the increasing Government health care and pension costs associated with an ageing population. Not recognising the income deferral aspect of retirement income inflates the present value of taxation revenue at the expense of a balanced, inter-temporal, view of future Government costs.

Taken overall, this suggests that a lower tax rate on savings is justified.

4.2 Development of New Zealand's financial system

As discussed above, a tax system that biases investment away from more profitable (from a national standpoint) but more heavily-taxed investments will stunt national income and hence savings¹⁶. As there are significant benefits to be gained from encouraging a broad range of investment, any policy change should provide as level a playing field as possible for all types of investment.

As outlined above, there are currently disparities in the New Zealand system between the taxation of various savings investments. Accordingly, in order to achieve this "level playing field" either those investments currently receiving favourable tax treatments need to be taxed more or those investments currently disadvantaged need to be taxed less. In practice, it is likely that a mixture of these approaches is likely to achieve the best result. Any policies introduced will need to be balanced and not at the expense of the need to encourage a higher level of national savings. New Zealand's system currently compares well internationally with relatively simple rules with broad application. From a compliance point of view, this approach is to be encouraged in any changes made.

In respect of the taxation of residential housing, external commentators such as the OECD have recommended the introduction of both a tax on capital gains and the value of occupancy (imputed rental) for owner-occupied homes¹⁷. Given the current favourable treatment and the comparatively high reliance by households on this single type of investment, some level of additional taxation is required to assist savers in making more balanced investment decisions. Possible options for reform are outlined in paragraph 4.3.2 below

The PIE and KiwiSaver changes discussed above were positive steps towards providing tax incentives towards other types of investment but further tax reform is needed to encourage investment and develop New Zealand's financial system.

¹⁶ Supra, note 10

¹⁷ Supra, note 10

4.3 Tax Working Group considerations

We understand that the Tax Working Group is currently considering a wide collection of options for tax reform affecting many aspects of New Zealand's economy. We appreciate that any recommendations will need to balance competing requirements. We have not undertaken that overall exercise. We comment on a number of these options which the ISI views as having a specific impact on savings.

4.3.1 Goods and Services tax

As GST is widely considered an "efficient" tax, it is an obvious candidate for increasing Government revenue (or keeping revenue constant in conjunction with other reforms).

However, any such reform, will need to consider the impact of the change to the rate of GST on savings.

All things being equal, an increase in the rate of GST will increase costs. Accordingly, we expect any increase in the rate of GST will be combined with adjustments to compensate those affected.

However, any increase in the rate of GST will increase the overall cost of saving for investors as intermediation costs will increase. One potential solution would be to introduce a reduced input tax credit system similar to Australia's as part of any overall package. This may help balance both the need to protect Government revenues with the need to encourage savings.

Accordingly, any change to the rate of GST implies that consideration must also be given to the GST base, in particular, the deductibility of GST paid.

4.3.2 Taxation of real property

Where there appears to be the greatest economic distortion in investment in real property is where investment is made in less productive areas with lower than expected tax revenues. This is most noticeable in respect of investment in residential rental property.

The Tax Working Group has recently considered a number of potential reforms to counter this distortion such as the introduction of a general capital gains tax, introduction of a land tax, introduction of a Risk Free Return Method ("RFRM"), denial of interest deductions and a denial of depreciation deductions.

4.3.2.1 Capital gains tax

The ISI is cautious on the issue of applying a comprehensive capital gains tax which could result in discouraging investments which are not the intended target of such reform. We consider that a capital gains tax targeted towards residential property will be difficult to apply and may cause boundary issues as to where specific exemptions apply. In addition we consider that the risk in applying a capital gains tax solely to residential rental property would be that as only part of New Zealand's asset base would be covered by this tax, this could result in an equal

distortion away from this investment type. On this basis, the ISI does not view a capital gains tax as providing a useful solution and considers other options may be better suited to addressing this distortion.

4.3.2.2 *Land tax*

The introduction of a land tax is likely to have a wider impact than on just those investments which are the target of such a reform. However, any exemptions to narrow the effect of the tax are likely to reduce the efficiencies of such a regime and its ability to generate taxation revenue. Given the overall impact that such a regime would have on the asset bases and balance sheets of the country and individual businesses, we consider that a land tax is not a preferred option.

4.3.2.3 *Risk free return method*

The introduction of an RFRM would deem a risk free rate of return to be income of an investor based on the net market value of their investment. The effect of a net-of-debt valuation would be to allow a deduction for interest expenditure (at the risk free rate) but deny all other deductions for expenditure incurred by the investor.

In the residential rental context, this approach has some appeal and if properly implemented would operate to reduce the current tax distortion towards this method of investment. However, as this method would create a deemed return for investors even in a declining market, there are likely to be practical difficulties around the “saleability” of such a reform.

ISI’s comments are based on investor reaction to the FDR rules and how they apply to them.

4.3.2.4 *Denial of interest deductions*

As a large proportion of real property is debt financed it makes economic sense that interest deductions are allowed. This properly reflects, in the tax base, the returns to equity and debt from real property investment. [If there are concerns around the gearing of property investment, these concerns are better targeted through commercial and regulatory capital and gearing requirements rather than tax legislation.] *can be deleted*

We therefore do not support the denial of interest deductions.

4.3.2.5 *Denial of depreciation deductions*

A depreciation deduction is allowed on the basis that the property held declines in values while used to produce income. The assertion for real property is that repairs and maintenance expenditure maintains the value of the property (i.e. so that it does not decline in value). This means that depreciation should not be allowed.

However, to the extent that the property does not increase in value, actual expenditure should be allowed. The current rules allow this to the extent the expenditure is classified as revenue

repairs and maintenance expenditure. To the extent, the expenditure is classified as capital, a deduction is denied.

Investments in real property can be broadly divided into three groups; residential rental property, industrial property and commercial investment property.

Residential rental properties are often a single investment used to derive rental income for their investor. As, historically, the value of these properties has increased overtime these investments have often been later sold for a capital gain. Given these investments generally increase in value, there is no justification for allowing a depreciation deduction. In the absence of a comprehensive capital gains tax, allowing depreciation loss deductions for residential rental buildings does not represent a coherent approach and encourages tax mitigation techniques. (The relative values of land and buildings can be manipulated to meet the non-taxable land/taxable buildings border).

Industrial property is more properly viewed as merely a requirement of a company's business or an investment in future revenues rather than as an investment in itself. The property is used in order to generate the income of the business which is subject to tax.

Commercial property is in practice usually aggregated in a unitised or traded investment vehicle rather than held as a single investment. Accordingly, the gains from this investment usually make up part of a portfolio return to a wide number of investors and contribute to the economy's savings and productive capacity.

As commercial and industrial property investments contribute to New Zealand's productive capacity, and do not produce the same investment distortion as residential rental properties, depreciation deductions should be retained for these investments.

Further, denying depreciation for these investments would lead to practical issues around the application of the capital/revenue distinction. A consequence of denying depreciation is that expenditure which maintains the value of the property should be deducted. Some of this expenditure will be classified as capital expenditure due to the historical tests applied to determine revenue versus capital maintenance expenditure. Redrawing the revenue border will create uncertainty.

We consider that depreciation deductions should be allowed for industrial and commercial real property investment. However, on the basis that depreciation deductions are not reflective of the decline in value of residential rental investment (and therefore that the tax base is understated), depreciation deductions can be denied for residential rental properties.

4.3.2.6 Summary

We consider that either the introduction of a RFRM or denial of depreciation deduction for residential rental property investments is likely to have the greatest impact on reducing the distortion towards investment in residential property.

4.3.3 Nordic or dual tax systems

We understand that the Tax Working Group is also considering the merits of a “Nordic” tax system where capital and labour income are taxed at different rates (usually capital at a lower rate).

Lowering the rate of tax on savings should encourage an increase in the level of national savings. However, in practice, these regimes can be complicated to implement and administer.

To a certain extent the benefits of such a system are already present in the New Zealand savings system through the PIE regime. As individual investors are effectively taxed at their marginal tax rates (capped at 30%) and PIE income is not taken into account in determining social assistance, this effectively creates an immediate tax benefit towards the accumulation of savings. If further incentives are required, these would be better achieved by creating further specific benefits, combined with either greater “lock-in” requirements or compulsory superannuation.

4.3.4 Single economic markets

We recommend that any reforms undertaken should be balanced with the ongoing goal of closer economic relations with Australia. The ISI supports these aims and considers that many benefits would flow to New Zealand’s economy from mutual recognition of savings regimes. Accordingly, any tax reform in respect of investment, should consider issues such as the portability of superannuation schemes between New Zealand and Australia and mutual recognition of imputation credits/franking credits.

4.3.5 Annuities and income streams during retirement

As important a consideration as the accumulation of retirement savings is the tax treatment when these savings are drawn down (i.e. the period after accumulation). Although the taxation of specific investments is likely to be at a level too detailed for the Group, the taxation of annuities and, more generally, income streams during retirement is a specific issue that needs to be addressed.

The implementation of KiwiSaver and a focus on savings should produce over time significant funds for investors. It is important that the tax system does not discourage the continued investment of those savings until they are needed for retirement consumption.

Depending on individual circumstances and needs, different retirees will need differing levels of income as they transition towards retirement. It is important that the tax system recognises the deferred consumption of this capital so as to not hamper this flexibility or discourage long term savings. The tax system can also play its part in encouraging income streams in retirement rather than large lump-sum consumption expenditure.

By way of example, the current tax rules have not assisted in the development of a fully functioning annuities or income stream market which has discouraged a useful means of drawing down retirement savings. We consider that the tax rules need to clearly provide for taxation on returns of income and not capital when the income amount is paid to an annuitant.