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[] November 2021

Taituarā submission on the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill

Introductory comments

Taituarā appreciates the opportunity to submit on the proposed changes to local authority taxation included in the Taxation (Annual Rates for 2021–22, GST, and Remedial Matters) Bill.

Taituarā is the national membership organisation for local government professionals. Its purpose is to promote and support professional management in local government. As part of its role it advocates on behalf of its members, including by providing input into proposed changes in Policy that are relevant to its members, such as this.

This submission endeavours to capture issues arising out of the proposed legislation that impact across the spectrum of local authorities, acknowledging that the impact of the proposed reforms may differ depending on the size and financial position of any particular entity.

In April 2021, Taituarā (together with Local Government New Zealand) provided Officials with comments on Inland Revenue's findings and recommendations following its review of the policy settings and practices relating to the taxation of dividends derived by a local authority from a council-controlled organisation (CCO), port company or energy company. Taituarā recommended that a broader review of the tax regime for local authorities/CCOs be undertaken. It also questioned whether the comparison made by Inland Revenue between local authorities/CCOs and State Enterprises/the Crown was appropriate. In the State Enterprise/Crown situation, the Crown receives funds whether they are paid in dividends from a State Enterprise or in tax by the State Enterprise. This is not the case for local authority groups. Simply put, if more tax is paid that money is not available for local initiatives.

Taituarā remains of the view that rather than tweak the legislation as is proposed, a broader review of the income tax position of local authorities and their subsidiaries should be undertaken. While Taituarā understands the concerns raised by Officials, these concerns seem to be limited to the actions of a very small number of local authorities. Taituarā considers the approach taken will impact beyond the areas of concern and have a negative impact on *all* local authorities which will likely have a flow-on effect for both ratepayers and local charities.

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Taituarā also reiterates that there is a vast amount of reform that is already impacting on local authorities, including Three Waters Reform, the Future for Local Government Review and RMA reform. Taituarā submits that these changes should be finalised before any tax changes are implemented. These reforms will likely have a significant impact on the structure and funding of local government. Rather than implementing ad hoc changes now that may not be fit for purpose after these reforms are completed, Taituarā submits that it would be more appropriate to defer making changes now and review the policy settings for local government taxation post these reforms. This will ensure any changes will be fit for purpose.

We have set out below Taituarā's submissions on the specific proposals. While Taituarā is broadly supportive of some of the changes, including the proposal to exempt dividends from a CCO and most of the imputation changes, Taituarā does not support the proposed interest deduction changes or the proposal to remove the donation deduction for local authorities which will have a substantial economic cost for a number of local authorities. This cost will directly impact on ratepayers with likely rates rises across the country.

Specific proposals

Dividend received by local authorities from wholly owned CCOs will be tax exempt

Taituarā is generally supportive of the proposal to exempt dividends derived from a wholly owned CCO, port company or energy company. It notes that this should not result in a significant decrease in the overall tax paid, given most CCO dividends are fully imputed. The proposal will however simplify and reduce the cost of local government group restructures by allowing the free-movement of profits and other value within local authority groups.

However, Taituarā considers that the proposal does not go far enough, as it excludes from the exemption dividends from CCOs that are not wholly owned. There are many CCOs that are, for example, owned by several local authorities or by a mix of local authorities and other community organisations. There is no apparent policy reason to not exempt dividends derived by local authorities from all such CCOs, port companies and energy companies.

Taituarā also queries whether the exemption should be extended to all income derived by local authorities from CCOs, port companies and energy companies, not just dividends. Once implemented, a large proportion of local authorities will continue to be required to file income tax returns to report a minimal amount of taxable income (such as from small wharfs used minimally by commercial fisherman, despite these activities making a loss year-on-year). Local authorities will therefore bear the compliance costs of having some income within the tax net but this cost will not generate much, if any, tax revenue for the Crown. Taituarā questions whether the need to meet these compliance costs is a good use of ratepayer funds.

Interest deduction changes

The Bill proposes limiting a local authority's deductions for finance costs to costs incurred:

- On loans made to a council-controlled trading organisation (CCTO)
- On borrowings to acquire shares in a group company that is a CCTO; and

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- On base price adjustments for financial arrangements involving CCTOs.

The Officials' Commentary on the Bill states that a local authority should only be allowed a deduction for costs incurred to the extent they have a nexus to the derivation of taxable income by the local authority. It appears that Officials are concerned that a small number of local authorities have managed to obtain a deduction for finance costs without a nexus to taxable income. While Taituarā acknowledges the concern, it submits that the proposed legislation limits the ability for local authorities to deduct finance costs well beyond the intended scope, by restricting deductions in situations where there is a clear nexus to taxable income. Taituarā considers that this is unnecessary. It submits that any concerns could be addressed either by a more targeted limitation, or by use of the general anti-avoidance rule to address specific situations.

As currently drafted, finance costs will only be deductible when the finance is related to a CCTO. But, local authorities are taxable on amounts derived from all entities within the definition of a CCO in the income tax legislation as well as income from port companies and energy companies i.e. not just from CCTOs. For example, under the proposed legislation, if a local authority raises funds to on-lend to a CCO that is not a CCTO, it will not be entitled to a tax deduction for the interest it pays on the funding, but it will be taxed on any interest it derives from the CCO. This creates a tax mismatch, which will increase the cost of the underlying funding.

The decision to limit interest deductions to finance related to CCTOs appears to be a definitional error. A CCO is defined in both the Local Government Act 2002 and the Income Tax Act 2007. In the tax legislation, the definition of a CCO includes both a CCTO as defined in the local government legislation and other specific entities within the Local Government Act CCO definition. Income derived by a local authority from all of these entities is taxable (subject to the proposed dividend exemption). The proposed legislation however references a CCTO, not a CCO as defined in the Income Tax Act. A CCTO is defined in the local government legislation and it is narrower than a tax CCO. Therefore, by only including CCTOs within the interest deduction proposal, funding for other taxable CCOs is excluded. Taituarā submits that these definitions should be carefully reviewed, to ensure the draft legislation will apply as intended. If this is an intentional decision, then Taituarā requests that Officials explain why.

If the deduction for finance costs remains limited to CCTO funding, it will have a significant economic impact on local authorities, who often borrow to fund CCOs. Local authority groups will be able to structure around this change by, for example, CCO's raising funds directly. However, even if structured around, it is likely that this amendment will increase the cost of funding for local authority groups, as it will limit the ability of local authority groups to centralise their funding function.

Taituarā submits that this proposal should be reviewed and at a minimum widened to include borrowings related to all CCOs, port companies and energy companies.

Further,Taituarā submits that Policy Officials explicitly confirm whether interest deductions for funding of holding companies that do not in themselves have a trading activity, and shared service entities that are intended to 'break even', will be deductible.

Denial of donation deduction

The Bill proposes preventing a local authority accessing the corporate deduction for a charitable or other public benefit gift. Officials' note that local authorities have been consistently the largest group of companies that have used this deduction, despite their substantively tax-exempt status. Officials are

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concerned that a local authority can offset donations against taxable income from CCOs, leaving excess imputation credits that can be converted to a tax loss and offset against the taxable income of CCOs under the loss grouping rules.

The Commentary on the Bill states that the corporate gift deduction is intended to encourage companies to redirect part of their otherwise taxable income to charitable, benevolent, philanthropic or cultural purposes and that it is not intended to provide a tax subsidy for local authorities whose legislated purpose is to promote the social, economic, environmental and cultural well-being of communities.

Taituarā submits that this proposal is not sound from a policy perspective and that it is unnecessary in the light of some of the other proposed changes. The current donation deduction allowed for companies was introduced following a discussion document, *Tax incentives for giving to charities and other non-profit organisations* released in 2006. The forward to that document states:

> *The options canvassed in this discussion document are aimed at reinforcing and encouraging giving by providing further incentives to those who donate money and/or give of their time and skills to charities and other non-profit organisations. …*
>
> *Among the reasons that the government wants to further encourage the act of giving to charities and other non-profit organisations is that they assist the government in furthering its own social objectives, such as increasing its support to those members of society in need and the provision of community benefits generally.*

Currently, the donation deduction encourages local authorities to donate more to the charitable sector. This is clearly in line with the intended purpose. The fact that local authorities have a role in promoting social, economic, environmental and cultural well-being, does not mean that they have an obligation or ability to fund local charities. The existence of the tax deduction enables local authorities to direct more funding to such charities than they would otherwise be able to do. As the discussion document states, this assists the government in furthering its own social objectives. Any decrease in charitable giving by local authorities will likely put further pressure on central government to replace that funding. In the light of this policy objective, Taituarā submits that there is no sound policy reason to prevent local authorities from claiming a deduction up to their level of taxable income, in the same way as any other corporate entity.

Taituarā also considers that the proposal to exempt dividends from wholly owned CCOs, port companies and energy companies, will effectively remove much of the benefit of the corporate donation deduction for local authorities, without the need to introduce the proposed exclusion. The proposed exemption of dividends will significantly reduce the taxable income of local authorities and therefore the level of donation deduction they can claim. If, as submitted, dividends from all CCOs, port companies and energy companies, is exempt, then the level of donation deduction available to be claimed will be significantly reduced in any event.

Taituarā notes the economic impact of this change on local authority finances. The proposed change would remove an annual tax deduction of approximately $47m[1] across the sector. This will result in

[1] Per the Regulatory Impact Assessments Statement to the Taxation (Annual Rates for 2021-22, GST and Remedial Matters) Bill - page 31.

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additional annual tax of approximately $13.2m[2] which will either need to be funded by ratepayers or will result in a drop in charitable giving. As noted above, a decrease in charitable giving will likely place pressure on central government to provide additional assistance.

Imputation changes

Taituarā is broadly supportive of the proposed changes to the imputation regime. The current practice for most local authorities is in line with the proposed changes. Therefore, these proposals should have limited impact.

It does however request clarification on whether imputation credits will still need to be attached to an exempt dividend. Given the potential for group restructures, particularly in the light of local government reform, Taituara submits there should not be a requirement to attach imputation credits to exempt dividends in a similar way to how the rules operate for State Enterprises.

Taituarā also submits that the restriction on the ability for local authorities to convert excess imputation credits to a loss should be limited to imputation credits received from entities within the same group. Losses can only be offset where the group loss offset rules are met. Imputation credits received from non-group CCOs should be able to be converted to a loss as there is no risk that the resulting loss can be offset against the income of the entity paying the dividend.

Conclusion

In summary, Taituarā submits that the proposed changes to interest and donation deductibility overstep the identified concerns of Officials and will have a significant economic impact on the financial position of local authorities. This will place additional pressure on ratepayers and local charities. Given the additional tax will go directly to Central Government, which will likely face additional pressure to, in turn, direct additional funding to regions across the country, there does not ultimately appear to be a rational reason for the proposed changes.

Taituarā further submits that a broader review of the policy settings for the taxation of local authorities should be undertaken once the current round of reforms is completed.

Taituarā would welcome the opportunity to appear before the Finance and Expenditure Committee to answer any questions on its submission.

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Yours sincerely

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[2] Ibid.

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