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NEW ZEALAND

ELECTION 2023 – A SEA OF BLUE

October 14th 2023 was Election Day in New Zealand, which has an electoral term of three years, the red team of Labour coming out victorious in both 2017 and 2020.

However with the present cost of living crisis in New Zealand, including ever increasing residential mortgage lending rates, which is having a profound negative impact on the average household at the moment, a change in Government was somewhat expected, although perhaps not the sea of blue in support of the National Party, which we encountered on Saturday night when the votes were counted.

In New Zealand, we do not have a first-past-the-post electoral system (party with the most votes wins) like many of you may experience in your own countries. Instead for a number of years now, we have an MMP system – mixed member proportional. So the New Zealand parliament has 120 seats, and the number of party votes each party gets determines the number of seats that party will have in parliament. Obviously to control parliament therefore, a party which wishes to govern alone requires 61 seats. Often however a party alone will not reach the controlling threshold, and consequently they will need to find a coalition partner to govern with them.

While a number of votes are yet to be countered, Saturday night's provisional result saw National win 50 seats, and their usual coalition partner, Act, win 11 seats – so 61 seats and only just the required majority needed to govern reached.

However this article, being expressly written for our Taxpresso publication, is not actually about New Zealand politics, but instead about the likely tax changes which will now come about as a result of the change of Government. I will cover the three main proposed changes here.

The first and easiest is understand, is with respect to personal tax rate thresholds. In New Zealand, we presently have 5 tiers of personal tax rates, the next tier taking effect as your income exceeds a certain threshold. However those tier thresholds have not been inflation adjusted for some time, which has led to tax-bracket creep – incomes increasing due to inflationary pressures, which push the taxpayer into the next tax bracket, even though actual incomes in real terms have not changed.

So based on pre-election promises made, the thresholds will adjust:

- 10.5% $0 up to $15,600 (presently $14,000)
- 17.5% on $15,601 to $53,500 (presently $48,000)
- 30% on $53,501 to $78,100 (presently $70,000)
- 33% on $78,101 to $180,000
- 39% on $180,001+

The second is with respect to residential land in New Zealand. Presently New Zealand does not have a capital gains tax. So if you buy residential land (either for your own home or as an investment asset), you can subsequently dispose of that land and potentially pay no tax on any gain you have made due to the increase in value since you acquired the land.

However to catch so-called speculators (those who buy and sell land within a relatively short period of time to make a non-taxed gain), in 2015 a two-year bright-line test was introduced – sell residential land within two years of acquiring it, then unless the land was used as your main home, any gain on disposal is taxed.

Now while a two-year bright-line test seemed fair to most from the respect of catching the so-called speculators, the Labour government in 2018 increased the bright-line period to five years, and then in 2021 to ten years (although with a new build exception which retained a five-year period). What should also be noted here, is that for a long time the New Zealand tax system has contain a rule which says that if a person buys land with an intention or purpose of disposal at the time they buy it, then the land disposal gain is taxable whenever sold. So arguably therefore, the Inland Revenue already had the power to tax the so-called speculators, without the need for a bright-line rule to be introduced.

National has now promised to reduce the bright-line period back to two years, with effect from July 2024. Additionally, if the residential land disposed of post July 2024 was acquired pre-July 2022, then the bright line rules will no longer have application to that disposal.

Finally, what would have to be the most unpopular tax amendment which the Labour government introduced during their recent term, was the removal of tax deductibility for interest paid on residential land debt, effective from October 2021 (although phased out over a four year period). So borrow money to acquire a residential rental property – the interest on those borrowings no longer tax deductible to reduce the tax payable on the rental income derived.

National has however promised to reinstate the interest payment tax deductibility, although on a phased basis, which will certainly be a welcome relief to numerous investors.

All that remains now is for the new Government to live up to their pre-election promises – only time will tell in that regard.

Complied by Richard Ashby on October 2023

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PAKISTAN

TAXING THE DIGITAL ECONOMY

"A revolution is not an event, but a process!" Mankind has witnessed several revolutions which have shaped the world we live in today. Ranging from the French Revolution to the American Revolution but overtime revolutions have evolved or switched from changing the political landscape to the economic landscape of the world. The last greatest revolution of such kind being the Industrial Revolution of the 17th Century. However, during the past three decades, humanity has witnessed a different kind of revolution which has given a completely new meaning to the word "Globalization" and brought about a radical change to the competitive landscape of businesses operating around the globe. This revolution is the era of Internet/ Digitization or as one might term it the era of ***"Digital Economy".***

Corporations operating in this era of ***"Digital Economy"*** are no longer dependent on a physical presence in order to operate or sell their products/services. Ventures such as Netflix, Amazon, Alphabet (Google) have developed a business model which utilizes the power of the internet in a way where they sell their goods/ services to the entire world without being dependent on a physical presence of an office for that matter in a particular country.

This disruption in the traditional methods of operating a business has resulted in exponential increase in profits for international organizations with increase in customer base as well as low costs aided by this digital era. Consequently, these high profits have raised the eye brows of the revenue exchequers of various economies around the globe. Even though the business models have been revolutionized, the taxation laws have not evolved at the same pace. It has been realized that the taxation laws and the concept of creating a taxation right based on the physical presence or a permanent establishment (PE) of an entity in a country has become outdated and many businesses are using this fact to their advantage by shifting their profits to countries with a lower rate of taxation.

The Organization for Economic Cooperation and Development (OECD) is known to work with various Countries around the world and setting international standards in an attempt to create a fair base of taxation for each country and preventing ***"Base Erosion and Profit Shifting" (the usage of tax planning techniques by Multi-national group of companies to shift profits from high tax rate economies to a lower tax rate economy).***

Thus, the OECD has carried out extensive research and meetings with member jurisdictions after which first it had issued the "***Addressing the Tax Challenges of the Digital Economy, Action 1 – 2015" report published on October 05, 2015*** wherein the problem of taxation of digital economies was highlighted and it was proposed that there is a need to revisit the standards set by OECD which create a taxation right over an amount of income for a particular country/jurisdiction and a number of solutions were floated around and discussed. Subsequently, an interim report was issued by the OECD in 2018 wherein the need to come up with a globally accepted solution was discussed and member countries had proposed to take interim measures till a consensus is reached.

A two pronged approach has been proposed by the OECD as possible solutions for solving this global dilemma. These solutions entail the following:

1. **A revised profit allocation and nexus rule:**
   Under this solution, a proposal for the concept of a ***"digital PE"*** based on the ***"significant economic presence"*** measured through the barometer of the customer base of a digital business has been made. Through this proposal, taxation rights would no longer be linked to a physical presence or the traditional Permanent Establishment but rather on the basis of customer base or economic value creation of a digital business entity.

2. **A Global anti-Base Erosion proposal. (GLOBE):**
   The second proposal involves a global re-engineering of the current Base Erosion action plan being implemented. One such initiative agreed under this is ***"income inclusion method"*** involving chargeability of tax on the income of a multi-national group company (situated in a low tax jurisdiction) with the income of its Parent Company. This method is similar to the tax introduced on Controlled Foreign Companies but rather it would be on active business income.

   Another initiative agreed is the ***"tax on base erosion or profit shifting payments"*** which would involve disallowing expenses booked by a particular Company which it would use as a means to shift profits to a tax haven or a lower tax jurisdiction.

Now it seems like the OECD has come to a consensus amongst its member countries and vide its statement dated October 08, 2021 and as of December 16, 2022 the above proposed solutions have been agreed by 138 member countries.

Our neighboring country India was one of the first countries to take initiative based on the proposals of the OECD by adopting a unilateral tax called the "Equalization levy" through its Finance Act, 2016. This tax in a nutshell is a direct tax at the rate of 6% withheld by the recipient of a digital service while making payment to a non-resident digital business against specified services such as advertisement services. This ensures that revenue being earned by a non-resident digital business does not escape taxation.

Many countries since then have followed suit including the ***"Digital Services Tax"*** proposal made by the European Union in 2018. This tax being similar to the Indian Equalization Levy aimed at charging a 3% tax on digital services being provided in the Economy applicable on both resident and non-resident service providers. However, these two taxes are different in terms of their scope i.e. the types of revenue being taxed and the person being subject to this tax. The EU Digital Services Tax having a more targeted approach to the type of services being taxed than compared to the Indian Equalization Levy.

Pakistan has also taken initiatives in order to tax such digital businesses by imposing a withholding tax on payments being made to non-resident persons under Section 152 of the Income Tax Ordinance, 2001. However, several non-resident businesses generating revenue from Pakistan eventually claim exemption on the grounds that their business profits are taxable in the jurisdiction they are resident in as per the Agreements for Avoidance of Double Taxation.

Therefore, Pakistan needs to start exploring the concept of a digital PE or taxing non-resident companies in Pakistan based on the concept of significant economic presence. This would require an extensive amount of research and creating an entirely different field formation of taxation authorities dedicated to identifying significant economic presence of non-resident digital businesses operating in Pakistan similar to the more recently formed ***"Automated Exchange of Information Zone".***

Moreover, a government to government renegotiation of the Agreements for Avoidance of Double Taxation would be required in order to introduce the concept of this digital PE or significant economic presence. Although this would only be possible if the other jurisdiction agrees but taking a step towards the right direction is key at this moment. Presently, a large chunk of revenue earned in Pakistan by these digital businesses escapes taxation due to the outdated laws as well as bilateral agreements in operation.

Another initiative which Pakistan may take is to place restrictions on the expenditure being claimed which can be termed as "base erosion payments". These may include payments being made against royalty, fee for technical services or such other related nomenclature by a resident company to its Multi-national group Company resident in a low tax jurisdiction or a tax haven. As a result of this expenditure is claimed in Pakistan resulting in shifting of profits to a lower tax rate jurisdiction. Once restrictions are placed on such expenditures/payments, there would be a significant reduction in profits being shifted abroad as a result of such group company arrangements.

No doubt taxing the digital economy poses a great challenge yet with the arm's length approach and judicial allocation of international profits this challenge can be overcome. The world as we know is changing rapidly and if proactive measures are not taken to reengineer and develop a more up to date and robust taxation system in this digital era, then huge revenue losses would be faced by the Government Exchequer in the days to come.

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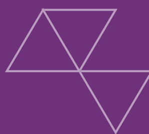

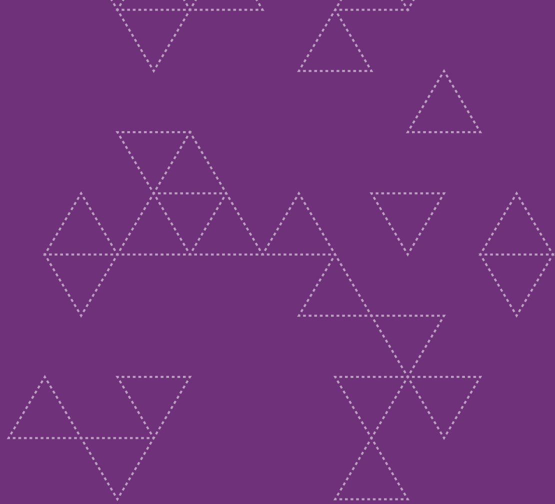

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