Hon Grant Robertson, Minister of Finance

Hon Stuart Nash, Minister of Revenue

Information Release
Tax Working Group
Policy reports, briefing notes, and emails

July 2019

Availability

This information release is available on Inland Revenue's Tax Policy website at http://taxpolicy.ird.govt.nz/publications/2019-ir-tax-working-group/overview.

Documents in this information release

#	Date	Title and description*
1	13 December 2018	**Taxpayer advocate recommendation from the TWG** This report briefs Ministers on the TWG's recommendation in its interim report to establish an independent taxpayer advocate service to assist small-to-medium sized taxpayers in managing disputes with Inland Revenue. Document type: Tax policy report (Inland Revenue) Reference: IR2018/762
2	14 December 2018	**Tax Working Group – officials' initial advice on potential tax reforms for Budget 2019** This report outlines officials' initial high-level views on key reform measures being considered by the TWG, ahead of the release of the final report. Document type: Tax policy report (joint) Reference: IR2018/800, T2018/3429
3	14 December 2018	**Inclusion of asset groups in a capital gains tax** This report assesses several design options of potential capital gains tax changes: staggering the application to different assets; excluding business assets; and excluding baches. Document type: Tax policy report (joint) Reference: IR2018/803, T2018/3721
4	11 January 2019	**Extending the taxation of capital gains: response to Ministers' requests on business impacts** This report responds to Ministerial requests for information on a tax-free threshold or exemption for small business owners from potential capital gains tax changes, and options to reduce valuation costs if a Valuation Day approach is undertaken. Document type: Tax policy report (joint) Reference: IR2019/015, T2019/18
5	17 January 2019	**Tax Working Group recommendations: Family home and second homes** This report discusses what the definition of the exempt "family home" should be for taxing capital gains, its relationship to the current "bright line" main home definition, and whether second homes (baches) should be included in the taxable base for capital gains taxation or be exempt. Document type: Tax policy report (joint) Reference: IR2019/014, T2019/035
6	24 January 2019	**Tax Working Group: Extending the Chair's appointment** This report seeks Ministerial approval for extending the appointment of the Chair of the TWG and attaches a letter to extend the appointment of the Chair to 30 June 2019. Document type: Tax policy report (joint) Reference: IR2019/032, T2019/120
7	28 January 2019	**Fiscal and distributional analysis [Redacted under s9(2)(f)(iv) of the OIA] KiwiSaver proposals** This report provides information on the distributional analysis of the TWG's KiwiSaver proposals. Document type: Tax policy report (joint) Reference: IR2019/013, T2019/1

#	Date	Title and description*
8	1 February 2019	**Tax Working Group final report** This is a covering report for the delivery of the TWG's final report to the Minister of Finance and the Minister of Revenue. It does not contain any advice. Document type: Tax policy report (joint) Reference: IR2019/040, T2019/174
9	1 February 2019	**TWG final report - Draft Cabinet paper and draft briefing materials** This report provides the Minister of Finance and the Minister of Revenue with a number of materials related to the TWG's final report. These materials are: • A Cabinet paper summarising the report's key findings. This Cabinet paper has already been publicly released and is available at http://taxpolicy.ird.govt.nz/publications/2019-ir-cab-19-sub-0176/cabinet-paper. • A 'covering note' that was intended to help inform possible communication materials around the final report. • An A3 that summarises key information from the final report. • A slide pack that summarises key information from the final report. Document type: Tax policy report (joint) Reference: IR2019/048, T2019/155
10	1 February 2019	**TWG final report – officials' companion advice** This report summarises officials' high-level views on the key recommendations of the TWG's final report and sought Ministerial direction for how to support them to deliver a potential tax reform package. Delivery of this report accompanied the delivery of the TWG's final report to the Government. Document type: Tax policy report (joint) Reference: IR2019/041, T2019/113
11	5 February 2019	**Further information on TWG issues raised** This report responds to issues raised by the Minister of Revenue at a meeting with officials. Those issues are: the economic effects of capital gains taxes in other jurisdictions, whether capital gains should be taxed at a lower rate than other income, and how the system of taxing capital gains recommended by the TWG compares with capital gains taxes in other jurisdictions. Document type: Tax policy report (joint) Reference: IR2019/031, T2019/175
12	8 February 2019	**Major design issues in the taxation of capital gains** This report seeks direction from Ministers on their initial views on key capital gains tax design decisions, including the tax rate, inflation adjustment, roll-over relief, capital losses, and the treatment of Māori collectively-owned assets. Document type: Tax policy report (joint) Reference: IR2019/061, T2019/246
13	11 February 2019	**Further information on potential distributional impacts of extending the taxation of capital gains** This report provides additional information on potential distributional impacts of capital gains tax changes. The two attachments to the report are already publicly available at https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-3970237-distributional-analysis-and-incidence.pdf and https://taxworkinggroup.govt.nz/sites/default/files/2018-09/twg-bg-distributional-analysis.pdf. Document type: Tax policy report (joint) Reference: IR2019/068, T2019/242
14	14 February 2019	**TWG final report – officials' companion advice, table of recommendations** This report provides officials' views on how the Government could respond to the recommendations made by the TWG. Document type: Tax policy report (joint) Reference: IR2019/062, T2019/243
15	18 February 2019	**KiwiSaver and the taxation of retirement savings** This report advises Ministers on the Chamberlain and Littlewood submission on tax concessions for saving. The report also provides a brief explanation of the Australian retirement income system. Document type: Tax policy report (joint) Reference: IR2019/081, T2019/297
16	20 February 2019	**High-level comparisons of Australia and New Zealand tax system** This note compares the New Zealand and Australian tax systems in light of the TWG's recommendations for extending the taxation of capital gains. Document type: Briefing note (joint) Reference: BN2019/095, T2019/422
17	22 February 2019	**Options for extension of tax on capital gains** This report provides advice on the option for taxing capital gains for all land and buildings (both residential and non-residential). Document type: Tax policy report (joint) Reference: IR2019/085, T2019/403

#	Date	Title and description*
18	22 February 2019	**Options for building a package of tax reform** This report provides fiscal context and costings to inform decisions on a possible reform package for Budget 2019. Document type: Tax policy report (joint) Reference: IR2019/103, T2019/341
19	28 February 2019	**KiwiSaver distributional scenarios – taxing share gains and TWG recommendations** This aide memoire analyses the impact of the TWG's proposals on the build-up of balances in KiwiSaver accounts for different income earners. Document type: Aide memoire (Treasury) Reference: T2019/538
20	4 March 2019	**Further advice on potential asset coverage** This report advises Ministers on two potential asset exclusions from capital gains taxation: excluding capital gains from corporate assets from a comprehensive capital gains tax, and exempting a second home from a tax on the capital gains from residential property. Document type: Tax policy report (joint) Reference: IR2019/111, T2019/563
21	4 March 2019	**Capital gains and labour income** This report advises Ministers on whether returns from entrepreneurship should be taxed at the same rate as other income. Document type: Tax policy report (joint) Reference: IR2019/116, T2019/558
22	4 March 2019	**Further information on fiscal impacts of potential tax reform options** This report provides information on the fiscal impacts of potential tax reform options. Document type: Treasury report Reference: T2019/512
23	6 March 2019	**Table – Tax Working Group recommendations** This report provides an updated version of a table from an earlier report (see document number 14 – IR2019/062, T2019/243). Document type: Tax policy report (joint) Reference: IR2019/128, T2019/610
24	6 March 2019	**Options for extending taxation on capital gains** This note attaches an A3 providing a high-level summary of the main choices in extending the taxation of capital gains. Document type: Tax policy report (joint) Reference: IR2019/132, T2019/618
25	7 March 2019	**Interactions between Tax Working Group and Welfare Expert Advisory Group** This report compares the findings of the TWG and WEAG reports. Document type: Tax policy report (joint) Reference: IR2019/122, T2019/531, MSD REP/19/3/172
26	7 March 2019	**Summary table: Options for extending taxation on capital gains** This report provides a summary of the table already provided in an earlier report (see document number 24 – IR2019/132, T2019/618), which compares options for taxing capital gains (by asset classes) against various measures. Document type: Tax policy report (joint) Reference: IR2019/134, T2019/634
27	11 March 2019	**Further advice on capital tax design issues** This report provides an analysis of benefits and costs to making exclusions and special rules within a capital gains tax regime. Document type: Tax policy report (joint) Reference: IR2019/142, T2019/664
28	15 March 2019	**Small business and KiwiSaver exemptions** This report provides preliminary advice on the potential design of capital gains tax exemptions for small businesses (including farms) and KiwiSaver. Document type: Tax policy report (joint) Reference: IR2019/154, T2019/760
29	19 March 2019	**Timeline for decisions: Tax Working Group** This briefing note seeks a discussion with Ministers over the timing of a response to the TWG final report. Document type: Briefing note (joint) Reference: BN2019/165
30	10 April 2019	**Taxing residential property – main home plus one exclusion rule** This briefing note discusses officials' preliminary views on the option of allowing a capital gains tax exclusion for the family home plus one other residential property. Document type: Briefing note (joint) Reference: BN2019/210, T2019/1071

#	Date	Title and description*
31	12 April 2019	**Cabinet paper: Government response to the Tax Working Group – final version for lodgement** This is a cover report attaching the Cabinet paper for the Government's response to the TWG, which was announced on 17 April 2019. The Cabinet paper itself is already publicly available at http://taxpolicy.ird.govt.nz/publications/2019-ir-cab-19-sub-0176/cabinet-paper. Document type: Tax policy report (joint) Reference: IR2019/213, T2019/1076
32	12 April 2019	**Speaking notes** Document type: Email
33	16 April 2019	**TWG response** Document type: Email

* Joint tax policy reports were prepared by Inland Revenue and The Treasury.

Information withheld

Some parts of this information release would not be appropriate to release and, if requested, would be withheld under the Official Information Act 1982 (the Act). Where this is the case, the relevant sections of the Act that would apply are identified. Where information is withheld, no public interest was identified that would outweigh the reasons for withholding it.

Sections of the Act under which information was withheld:

- 6(a) to prevent prejudice to the security or defence of New Zealand or the international
- 9(2)(a) to protect the privacy of natural persons, including deceased people
- 9(2)(f)(iv) to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials
- 9(2)(g)(i) to maintain the effective conduct of public affairs through the free and frank expression of opinions
- 9(2)(k) to prevent the disclosure of official information for improper gain or improper advantage

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Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

Tax policy report: Taxpayer advocate recommendation from the TWG

Date:	13 December 2018	**Priority:**	Medium
Security level:	In Confidence	**Report number:**	IR2018/762

Action sought

	Action sought	Deadline
Minister of Revenue	**Agree** to the recommendation **Refer** a copy of this note to the Minister of Finance	18 December 2018

Contact for telephone discussion (if required)

Name	Position	Telephone
Chris Gillion	Policy Manager	s9(2)(a)
Marie Pallot	Senior Policy Advisor	

13 December 2018

Minister of Revenue

Taxpayer advocate recommendation from the TWG

Purpose

1. This note briefs you on the recommendation from the Tax Working Group (TWG) in their interim report to establish an independent taxpayer advocate service. It also provides further information about what Inland Revenue currently does for small and unrepresented taxpayers, and seeks direction from you as to how you would like the recommendation from the TWG to be progressed by officials.

2. In their interim report, the TWG recommended the establishment of a taxpayer advocate service in response to a perceived concern about taxpayers not receiving the assistance they might require in dealing with Inland Revenue, particularly in the formal disputes process. The TWG noted:

> The Group has also considered a proposal to establish a taxpayer advocate service that would assist certain taxpayers – such as low-income earners, small businesses and, individuals with English as a second language – in disputes with Inland Revenue. The advocate could play multiple roles, including the provision of advice, and facilitation and mediation services.
>
> The Group believes that a taxpayer advocate could play a valuable role in the fair resolution of tax disputes. The service would need to be functionally independent from Inland Revenue in order to serve as a credible advocate for the taxpayer in dispute, but it might be able to draw on back-office support from Inland Revenue. The Group suggests the structure of a Departmental Agency would be most appropriate. It would be contained within Inland Revenue and report directly to the Minister of Revenue, rather than the Commissioner of Inland Revenue.
>
> The Group recommends that the Government establish a taxpayer advocate service to assist with the resolution of tax disputes. The Group is also currently considering the merits of a truncated dispute resolution process for small disputes.

Extent and nature of the problem

3. The New Zealand tax system is premised on voluntary compliance and self-assessment. In practice this means that taxpayers file tax returns based on their understanding of how the tax laws apply to their circumstances.

4. Inland Revenue's approach to supporting taxpayers in understanding their tax obligations is to provide a broad range of advice products. These are described below. The formal disputes process (in the Tax Administration Act 1994) becomes relevant where taxpayers are unable to agree with Inland Revenue about the application of tax laws to their circumstances.

5. The extent and nature of the problem the TWG are seeking to address in their recommendation for an independent taxpayer advocate service is not immediately clear. Inland Revenue has received submissions noting that taxpayers are "burnt off" by the current formal disputes process because of the costs associated with it - largely the cost of obtaining external representation. This point was raised in a joint submission from the New Zealand Institute of Chartered Accountants (now Chartered Accountants Australia and New Zealand) and the New Zealand Law

Society to Inland Revenue in 2008. Following this submission and a discussion document, a number of operational changes were made to the formal disputes process. These changes are described in paragraphs 14 and 15.

Advice and assistance for small and unrepresented[1] taxpayers

6. Inland Revenue provides a broad range of advice products. These range from general advice (eg booklets and guides) through to taxpayer-specific advice (eg advice from the call centre, written guidance or in person). In addition to this, Inland Revenue provides several other services to small business in particular and these are outlined in the appendix. All this advice is provided to small taxpayers without charge.

7. One of the principles underpinning Inland Revenue's Business Transformation programme is that Inland Revenue should help taxpayers get things right from the start. This involves engaging with taxpayers at the right time to ensure taxpayers are best placed to accurately self-assess.

8. Disputes generally arise when Inland Revenue is reviewing a taxpayer's tax returns and the department identifies positions taken in tax returns that are inconsistent with Inland Revenue's view of the law. These issues may become subject to the formal disputes process if earlier agreement between the taxpayer and Inland Revenue is not possible.

9. As part of the Business Transformation policy work we noted that binding advice is difficult to obtain for small and unrepresented taxpayers, as the costs associated with obtaining a binding ruling from Inland Revenue can be quite significant. The Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill proposes that, starting 1 October 2019, the binding rulings regime will be more accessible to small-to-medium sized taxpayers, through a cheaper, more straightforward process which will not necessarily require the involvement of someone with specialist tax expertise to help complete the application forms.

The formal disputes process

10. The formal disputes process was introduced following the recommendations of the Richardson Committee in 1994. The purpose was to reduce the number of disputes by promoting an "all cards on the table" approach that would encourage the prompt and efficient resolution of tax disputes, promote early the identification of issues and ensure any litigation was well prepared for. The formal disputes process ensures that there is full and frank communication between the parties in a structured way within statutory time limits.

11. The formal disputes process is used as a last resort where taxpayers disagree with Inland Revenue about a substantive tax matter which cannot be resolved through the usual processes (ie in discussions with the relevant areas of Inland Revenue involved with the taxpayer's issue).

12. Inland Revenue does not assist taxpayers with the formal disputes process beyond providing information about matters of process (which includes the recent updating of the Inland Revenue website on disputes to make the process easier to understand) and the independent approaches adopted in the facilitation and adjudication phases. This is because of the potential conflict of interest involved.

[1] Unrepresented in this context refers to a taxpayer that does not engage the services of an accountant or tax advisor to help them manage issues that may arise with Inland Revenue. Measuring the number of unrepresented taxpayers is difficult as often taxpayers will only engage the services of an accountant or tax advisor when they are faced by an issue with Inland Revenue they need help with.

13. The formal disputes process starts with a notice of proposed adjustment ("NOPA") and is followed by a notice of response ("NOR") and a facilitated conference, after which the respective parties issue their statements of position ("SOP") setting out the facts and arguments relevant to their case. Inland Revenue reviews the case through its independent Adjudication function and the taxpayer is usually issued with a reassessment if the review is in Inland Revenue's favour. The taxpayer can then start challenge proceedings in either the Taxation Review Authority (TRA) or the High Court.

14. Several enhancements were made to the formal disputes process in 2010, including the introduction of facilitators to the conference phase. Facilitators are experienced, independent Inland Revenue staff who have not been directly involved in the dispute. The facilitation process has been positively received.

15. The other main change in 2010 was to provide clear administrative guidance about where the Commissioner, to reduce compliance costs for taxpayers, would agree to have a dispute "truncated" so that the full process did not need to be followed. Automatic agreement to truncation under the guidelines occurs when a dispute involves tax of less than $75,000. This means that for smaller disputes only one exchange of disputes documentation is required, followed by a facilitated conference. After the conference, the taxpayer can choose to take the case to court.

16. However, there is no easy answer to reducing costs associated with the formal disputes process for small and unrepresented taxpayers because it deliberately demands engagement between taxpayers and Inland Revenue. Further, the process requires identification of the facts and arguments to support understanding and resolution of the issue, and taxpayers will generally wish or need to be represented.

17. Statistically, we note that the number of cases that make it to the formal disputes process is quite low. On average over the past three years, the number of NOPAs issued was close to 500 per annum. The number of NOPAs reflects the fact that the Commissioner must issue a NOPA in order to reassess a taxpayer's self-assessment and that taxpayers who have failed to file a return (and accordingly have been issued with a default assessment by the Commissioner) must respond to the default assessment using the NOPA process. The number of cases that involve a dispute about how the law applies to a particular tax question is therefore considerably less than 500.

18. Post the NOPA stage, approximately 75 percent of cases are resolved following the conference stage, and more through the later disputes stages, such that only 50 to 70 disputes a year proceed to the adjudication stage and become eligible for possible challenge to the TRA or High Court.

19. A reason for a low number of cases subject to the formal disputes process could be because a significant number of cases can be resolved using other processes (such as Inland Revenue explaining the application of tax law or policy to the taxpayer's circumstances and/or the use of settlements). An underlying reason for this improved ability to resolve issues might be the risk-based audit approach adopted by Inland Revenue, meaning that Inland Revenue's resources are likely to be applied to more serious cases of non-compliance where the taxpayer's arguments are often weaker.

Response to the TWG's recommendation

20. At this stage we do not consider that there is a burning need for an independent taxpayer advocate service as recommended by the TWG. This is because we do not understand the extent to which such a service would resolve the problem perceived by the TWG.

21. Further, as Inland Revenue continues its Business Transformation programme, the way in which it supports and provides advice to taxpayers will change. For example, Inland Revenue's Customer and Compliance Services business groups are now centred around different customer segments (eg micro-business, small-to-medium sized business, significant enterprises). Structuring in this manner will help Inland Revenue better understand the different needs of the different customer segments, and will help Inland Revenue provide better-tailored advice products which should result in less disagreement over substantive tax issues.

22. If Ministers see merit in considering a taxpayer advocate service further we would suggest that officials begin consulting with stakeholders in the New Year to get a better sense of the main problem with the current processes.

23. If Ministers want to pursue this approach, we would report to you early next year on a consultation plan. In this report we would give an undertaking of the size of the job and what policy projects would need to be stopped or slowed down.

Fiscal implications

24. Funding to establish a taxpayer advocate service has been sought as part of a broader budget bid from Inland Revenue. The amount sought is a placeholder at this stage due to the early stage of policy development and advice.

Consultation

25. Treasury was consulted in developing this note.

Next steps

26. We propose to discuss the contents of this note with you at the joint Ministers' meeting on 18 December 2018, and seek guidance as to whether officials should undertake further work in this area.

Recommended action

We recommend that you:

agree to discuss the contents of this note with officials at the joint Ministers' meeting on 18 December 2018.

Agreed/Not agreed

refer a copy of this note to the Minister of Finance.

Referred

Chris Gillion
Policy Manager
Inland Revenue

Hon Stuart Nash
Minister of Revenue
/ / 2018

Appendix: Specific forms of advice for small and unrepresented taxpayers

a. **New to business** – Advisory seminars targeted at new businesses and new employers that explain new businesses' tax obligations and introduce new businesses to online resources that Inland Revenue and other agencies provide.

b. **Right from the Start** – Inland Revenue works to find early issues with filing or calculations and contacts small businesses to help resolve the issues as soon as possible so that they can meet their obligations going forward. This fits in with advice products (plain English guides and websites that explain Inland Revenue's interpretation of tax laws).

c. **Online tools** – Several online tools and returns are available that help small businesses meet their obligations. This includes calculators and downloadable resources.

d. **Workshops** – That show taxpayers how to use Inland Revenue's e-Services to file returns and make tax payments online, as well as where to find online resources that can be used to help make tax calculations.

e. **Visits from Community Compliance** – Community Compliance will visit businesses and offer them the opportunity to ask questions or raise issues. The visits are primarily educational, although there is some compliance work carried out after the visit to ensure that the business filings reflect the operations of the business that have been observed (eg checking that PAYE returns are being provided if the business has employees).

f. **Joint presentations with the Ministry of Business, Innovation and Employment** – Inland Revenue runs a stand at small business roadshows provided by the Ministry of Business, Innovation and Employment. These roadshows provide taxpayers with an ability to ask questions and be shown how to use Inland Revenue's online tools.

g. **1 on 1 advisory services** – These are available where customers are struggling with online self-help tools. Community Compliance will visit the small business and walk taxpayers through their obligations, the online tools, and show them how to calculate their liabilities and file returns online.

h. **Planned and scripted compliance activities** – Community Compliance also run planned and scripted compliance activities that focus on small businesses, typically looking at specific areas of tax that Inland Revenue observes taxpayers struggling with, eg specific help with fringe benefit tax.

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

POLICY AND STRATEGY

Tax Policy Report: Joint Report - Tax Working Group - officials' initial advice on potential tax reforms for Budget 2019

Date:	14 December 2018	**Report No:**	T2018/3429 IR2018/800
		File Number:	SH-13-7-8

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	Agree to discuss this report with officials at the Joint Ministers' meeting on 17 December	17 December
Minister of Revenue (Hon Stuart Nash)	Agree to discuss this report with officials at the Joint Ministers' meeting on 17 December	17 December

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Michael Sherwood	Analyst, The Treasury	s9(2)(a)	n/a (mob)	
Mark Vink	Manager, The Treasury		s9(2)(a)	✓
Matt Benge	Chief Economist, Inland Revenue			

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Joint Report - Tax Working Group - officials' initial advice on potential tax reforms for Budget 2019

Executive Summary

The purpose of this report is to help you prepare for the TWG's final report

The Tax Working Group will provide you with its final report in late January 2019. In order to meet the Government's timeline for enacting any significant tax reforms by mid-2020, you will need to make final decisions on key elements of proposed reforms within two months of receiving the final report, so that Cabinet agreement can be sought in early April. This will be a tight timeframe within which you will need to make complex policy decisions.

To help prepare you for this decision-making process, this report outlines officials' initial high-level views on the key reform measures that are being considered by the Group. All of these measures were included in the Group's interim report and/or have been discussed in the papers prepared by the Group's secretariat that have been provided to you. This report also provides a suggested process and timeline for officials to assist you in delivering a package of potential tax reforms in time for Budget 2019.

We are scheduled to meet you on 17 December to discuss this report. We are seeking your guidance on the following issues to help us in developing further advice early next year:

1. **Objectives** – your primary objectives for a package of tax reform, including your objectives on how to use the revenue raised.
2. **Capital gains design options** – what further information you would like on these.
3. **Tax reform packages** – your initial views on the shape of a package of tax reform, including whether you would like welfare measures to become part of a package.
4. **Ministerial engagement** – your guidance on how best to engage with you, other interested Ministers, and Cabinet over the coming months on these issues.

Officials would support extending the taxation of capital gains…

The Group's chair recently announced that the majority of the Group supports extending the taxation of capital gains. We agree that a broad extension of the taxation of capital gains (excluding the family home) would likely meet a number of the objectives in the Group's terms of reference, particularly the objectives to improve the fairness, sustainability and integrity of the tax system. It would also reduce the extent to which tax settings bias investment decisions, and thereby likely lead to a more efficient allocation of capital in the economy.

The Group's terms of reference also directed the Group to have due regard for the efficiency of the overall structure of the tax system, and noted the Government's objective for the tax system to promote the long-term sustainability and productivity of the economy. There are some downsides for efficiency associated with extending the taxation of capital gains. These stem from the resulting higher levels of taxation of saving and investment, lock-in effects, and compliance costs. On its own, extending the taxation of capital gains is likely to have a negative impact on productivity and efficiency in the economy (as would almost any measure which raises a similar amount of tax revenue).

Overall, the advantages and disadvantages of extending the taxation of capital gains would depend on how it is designed and how the revenue raised is used. A summary of our current views on the core design choices is provided in a table at the end of this executive summary.

…if implemented as a package with other complementary measures

In order to address the efficiency and productivity objectives outlined in the Group's terms of reference, extending the taxation of capital gains would need to be part of a package including measures to support business investment and productivity.

Of the measures considered by the Group, we would recommend those outlined in the table below. These measures would all address significant inefficiencies in the structure of the tax system that are currently acting (or would act) to bias decisions.

We would recommend measures 2 to 4 whether or not the Government was considering extending the taxation of capital gains (subject to revenue constraints). However, they would also be an important business offset for extending the taxation of capital gains. In respect of measure 5, the case for residential rental loss ring-fencing, in particular, is much reduced if capital gains are taxed more broadly.

Policy measure	Rationale	Indicative 5-year revenue impact (from 2021/22)
1. Extending income tax to include realised capital gains (excluding the family home)	Increase fairness, sustainability and integrity of the tax system	+$10 billion
2. Allow businesses to claim depreciation expenses on buildings	Encourage more business investment and improve efficiency of investment	s9(2)(f)(iv)
3. Allow businesses to deduct expenses for "black hole" expenditure	Encourage innovation and entrepreneurship	-$0.12 billion
4. Allow businesses to keep losses when the owner changes	Make it easier for small companies to expand	-$0.24 billion
5. Remove residential rental loss ring-fencing	Recognising that gains would be taxed, this would reduce upward pressure on rents and increase efficiency	-$1.3 billion (preliminary estimate, likely to be lower)

Note: These fiscal estimates are highly uncertain, preliminary, indicative, and are subject to further refinement. Projected revenue from extending the taxation of capital gains is likely to be revised downward because of new data that has become available in the last week. The revenue would build up slowly over time and be volatile.

We consider that a package with these core elements would be cohesive and effective in contributing to the Government's overall objectives for the tax system. This package would:
- make the tax system significantly more progressive
- increase fairness through a more consistent taxation of capital income (horizontal equity)
- improve revenue integrity and sustainability
- increase incentives to develop land for productive purposes, and
- improve business tax to better support investment, innovation and productive risk-taking.

The Government has choices about how to use additional revenue raised

The above core package would leave room for remaining revenue to be used for other priorities. We would expect the above revenue-negative measures to have a revenue cost of around a third to a half of the revenue raised from extending the taxation of capital gains over the first five years. Depending on the Government's overall priorities, the remaining revenue could be used for other revenue-negative tax measures, expenditure initiatives, reducing debt, or setting aside for future Budget decisions.

The Group's chair has announced that the Group has developed four illustrative revenue-neutral packages. Alongside the measures outlined above, two other changes considered by the Group as part of these packages are lifting the bottom threshold for personal income tax and increasing KiwiSaver subsidies.

The Group has not focused on personal income tax settings at middle-to-upper income levels, but the Government could consider investigating changes here if increasing efficiency and productivity is a priority.

In its interim report, the Group recommended that the company tax rate be kept under review, but that it should not be changed at this point. Reducing the company tax rate has advantages and disadvantages, but, again, could be considered if the Government wished to prioritise increasing productivity.

Officials recommend you begin to consider options now for how to use the revenue raised if a decision is made to extend the taxation of capital gains. However, we suggest you leave your final decisions until March, when you will have information about the updated fiscal outlook, the final reports of the Tax Working Group and the Welfare Expert Advisory Group (WEAG) and a clearer sight of other expenditure bids being considered at Budget 2019.

Officials recommend that any personal tax and/or welfare package is designed after Budget 2019

The Group's proposed personal income tax and KiwiSaver changes focus on distributional objectives. If the Government's objective is to target lower income households in particular, then including changes to welfare settings would likely be more effective than only making changes to personal income taxes and KiwiSaver.

The Government could announce tax reductions or some welfare measures at Budget 2019. However, officials would recommend delaying design decisions on personal tax and welfare settings until after Budget 2019. Deferring decisions would enable time to take account of the WEAG's recommendations and provide the necessary time to develop an integrated personal tax and welfare reform package.

The timelines for pre-legislative consultation and detailed design will be challenging

To enact legislation by mid-2020, the Government would need to make decisions on key elements of proposed reforms in April, then consult and decide on the details, and then introduce legislation by November 2019. Officials can meet this timeline. However, it requires consultation and decision making on a large number of detailed and interconnected issues in a short space of time. This timeframe would increase the risks of there being a need to make further legislative changes in future, which would impose higher uncertainty and compliance costs on taxpayers.

Because of these risks, officials recommend amending the proposed timeline, to introduce legislation in mid-2020 with effect from 1 April 2022. This would allow additional time for consultation and decision making, which would help ensure legislation is fit for purpose, well-understood, well-tested to ensure it achieves the Government's objectives, and workable.

Under either timeline, there would be significant administrative resource implications for Inland Revenue from developing and implementing comprehensive tax reform at pace.

Officials seek your guidance on how best to engage with Ministers and Cabinet

Officials plan to provide you with advice on where we agree and disagree with the Group's final recommendations when you receive the Group's final report in January. Our suggested approach for the months ahead is as follows:

Timing	Milestone
Late January	• Group submits its final report • Officials provide advice to Joint Ministers on Group's recommendations

February	• Officials report to Joint Ministers on:
	  o Key design choices for extending the taxation of capital gains
	  o Options for tax reform package measures
	• WEAG delivers its final report

March	• Final Joint Ministers' decisions on:
	  o Key design choices
	  o Tax reform package
	• Budget Ministers' meetings to agree key decisions for any Budget 2019 package

Late March	• Initial Cabinet consideration of key design choices • Cabinet decisions on initial response to WEAG final report and next steps

April	• Final Cabinet decisions on:
	  o Government's response to the Group's recommendations
	  o Design choices, for consultation in a discussion document
	  o Tax reform package

In addition, the Ministry of Social Development is developing advice to the Minister of Social Development on a process for responding to the WEAG report, which will need to consider the approach taken to respond to the final report of the Tax Working Group.

Alongside this timeline, we recommend you hold workshops with your Ministerial colleagues on the Group's final report. Subject to your approval, officials can liaise further with your offices on the timing and content of these workshops.

Extending the taxation of capital gains: summary of officials' initial advice on key design choices

Note: We have denoted design choices where we think there could be a substantive difference between the views of officials and the Group with an asterisk (*).

Design choice	Officials' initial advice	Para no.
*Scope**	A broad range of assets should be included in the tax base (subject to specific exclusions, such as the family home). A narrower range of assets would reduce equity and create new tax distortions.	30
Effective date	All gains made after a specified date ("Valuation Day") should be taxed, regardless of when owners acquired their assets. Excluding gains made on assets acquired before introduction would create an unfair distinction between asset owners, increase lock-in, and reduce revenue in the early years of the tax.	37
*Phasing**	All assets should be included in the base from the same date. Staggering the introduction of different assets into the tax base would increase compliance and administration costs, and create temporary distortions and inequities in the treatment of different asset classes.	44
When to tax	Tax should apply when the ownership of an asset changes.	49
*Rollover**	Rollover treatment defers taxation in situations where it would be fairer (or more efficient) not to collect the tax. As a general rule, to maximise fairness and equity objectives and minimise long-term lock-in, officials are likely to err on the side of limited rollover.	52
Tax rate	Capital gains should be treated like ordinary income and taxed at a taxpayer's ordinary tax rate.	57
*Treatment of losses**	As a general rule, tax losses should be able to be offset against ordinary income, although some losses on specific asset classes may need to be 'ring-fenced' (so they can only be offset against other capital gains) in order to manage integrity risks.	61

Page 7 contains a full table of contents of the issues covered in this report, to direct you to particular areas of interest.

Recommended Action

We recommend that you:

a **agree** to discuss this report with officials at the Joint Ministers' meeting on 17 December

Agree/disagree *Agree/disagree*

b **indicate** your primary objectives for a package of tax reform

c **discuss** the key design choices for extending the taxation of capital gains and what further information you would like on these

d **indicate** your initial views on the shape of a package of tax reform and whether you would like welfare measures to become part of a package

e **provide guidance** on how best to engage with you, other interested Ministers, and Cabinet over the coming months.

s9(2)(k)

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Manager
The Treasury

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Chief Economist
Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Tax Policy Report: Joint Report - Tax Working Group - officials' initial advice on potential tax reforms for Budget 2019

Purpose of Report

1. This report outlines officials' initial high-level views on the key reform measures that are being considered by the Group. It also provides a suggested process and timeline for officials to assist you in delivering a package of tax reforms in time for Budget 2019.

2. The report focuses on the most fiscally significant tax policy changes that form the Group's proposed packages. Other changes recommended by the Group are not included – for example, environmental tax changes, where the Group's proposals have fiscal impacts that are uncertain and over the longer term.

Structure of Report

3. This report is split into the following sections:

Section	What is covered	Page no.

Extending the Taxation of Capital Gains	• The case for extending the taxation of capital gains on realisation
	• The key design settings in extending the taxation of capital gains, including the choices around:
	  o What to tax (e.g. land, business assets, intangible property)
	  o When to tax (e.g. upon realisation including the exceptions when deferral of the taxing point may be appropriate)
	  o How to tax (e.g. the rate of tax to apply and whether capital losses should be ring-fenced to capital gains)
	• Engagement with Māori
		8

Tax Policy and the Fiscal Strategy	• The projected revenue from extending the taxation of capital gains.
	• Three potential approaches to a tax reform package:
	  o Revenue-neutral
	  o Fiscally-neutral
	  o Revenue-positive
		17

Revenue-Negative Measures	• Revenue-negative measures that could be funded from the revenue raised from extending the taxation of capital gains:
	  o Personal income tax or transfers options, including:
	    s9(2)(f)(iv)
	    ▪ welfare transfers
	  o Business and housing measures, including:
	    ▪ restoring depreciation on buildings
	    ▪ depreciation for seismic strengthening costs
	    ▪ expanding black hole expense deductibility
	    ▪ reducing restrictions on loss carry-forwards
	    ▪ removing residential rental loss ring-fencing
	  o KiwiSaver measures, including:
	    ▪ decreasing lower KiwiSaver PIE rates
	    ▪ removing tax on employer contributions to lower-income KiwiSavers
	    ▪ increasing the Member Tax Credit
		20

Summary of Officials' Views	• Officials' initial views on package composition	28
Next Steps	• The timeline for legislation and the process for further advice	29

Extending the Taxation of Capital Gains

The Case for Extending the Taxation of Capital Gains

4. The case for extending the taxation of capital gains on realisation depends on the Government's objectives, how the tax is designed and how the additional revenue is allocated. The following section summarises the advantages and disadvantages of extending the taxation of capital gains on realisation, and the key design choices.

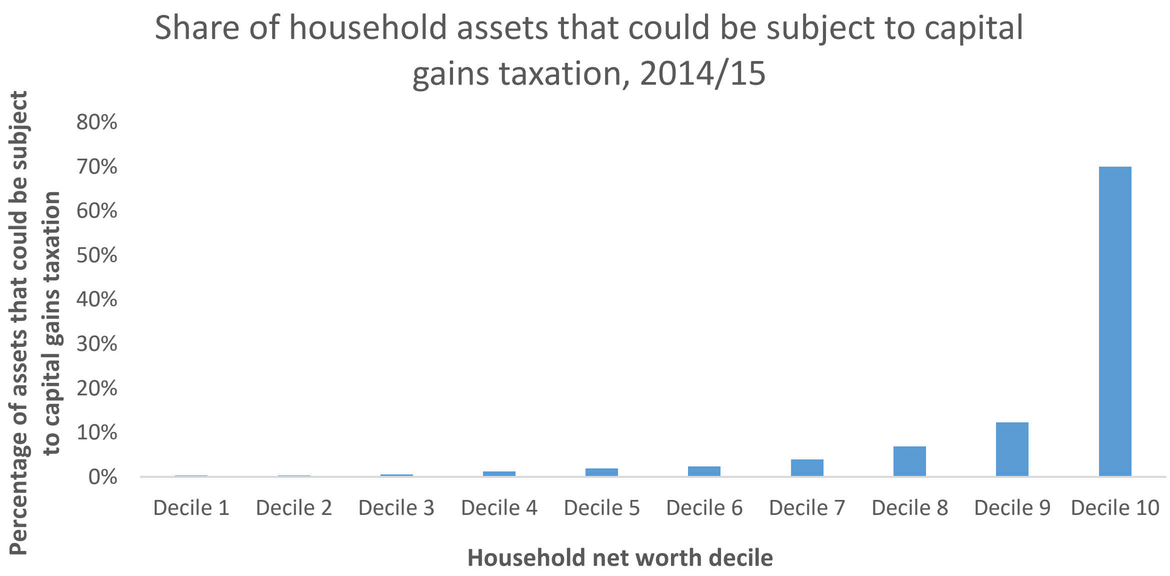
Advantages

Increasing the fairness of the tax system

5. Equity and fairness concerns provide the strongest rationale for extending the taxation of capital gains. Under current tax settings, people who earn income through capital gains pay less tax than those who earn the same amount of income from other sources. Extending the taxation of capital gains should help ensure they pay the same amount of tax, improving horizontal equity.

6. Extending the taxation of capital gains would also help increase the progressivity of the tax system, particularly with respect to wealth. Taxing more gains would likely lead to higher wealth individuals bearing a greater proportion of tax paid (see Figure 1 below). This is in line with your direction that the Group should consider packages that reduce inequality without increasing tax rates.

Figure 1:



Source: Statistics New Zealand (HES 2015) with subsequent Treasury calculations

Note: These estimates are based on the distribution of assets excluding cash, deposits and owner-occupied housing (proxy for assets subject to the taxation of capital gains).

7. Extending the taxation of capital gains would also be likely to increase the perception of fairness in the tax system. A sense of fairness is central to maintaining public trust and confidence in the tax system. A system that distributes the costs of taxation in a way that is perceived to be unfair will generate resentment and undermine social capital. Perceptions of unfairness erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance that underpins efficient tax collection.

Improving the integrity of the tax system

8. Extending the taxation of capital gains would support the integrity of the tax system, and bolster social capital, by reducing opportunities for tax planning and tax avoidance. Because capital gains are currently largely untaxed, there is a significant incentive for taxpayers to try to classify ordinary income as capital gains, in an effort to reduce their tax bills. Extending the taxation of capital gains should largely remove this incentive.

9. A particular integrity concern arises when there is a gap between the company tax rate and higher rates of personal income tax. New Zealand currently has a relatively small gap. The New Zealand model is for company tax to be levied at a rate of 28% on income accruing in companies, with a top-up tax of 5% of gross earnings when dividends are paid to shareholders on the top personal tax rate. However, in the absence of a capital gains tax it can be difficult to ensure that the top-up tax is paid. Extending the taxation of capital gains would help with current integrity pressures. The integrity benefits would be even greater if a future Government decided to increase the gap between the company and top personal tax rate.

Reducing the tax-bias in investment decisions

10. Extending the taxation of capital gains would help level the playing field between different types of investments (except the family home). By not comprehensively taxing capital gains, the current tax system creates a bias towards investing in assets that generate relatively more capital gains and less taxable income. This results in a misallocation of resources away from investments that primarily produce income that is taxable to the investor. Extending the taxation of capital gains would help address this misallocation of resources by increasing the neutrality of taxation applied to different investments. This would help with improving productivity and efficiency.

Sustainability of the tax base

11. New Zealand, like other countries, faces growing fiscal pressures from an ageing population. If the proportion of capital income relative to labour income increases, and capital gains remain untaxed, then it is possible that taxes on labour income will have to increase, or Government spending will need to decrease.

Revenue

12. Extending the taxation of capital gains would be likely to provide a growing revenue base for the future. Capital gains are the single largest source of income that most other OECD countries tax and that New Zealand largely does not. The additional revenue could be used to decrease taxes in other areas, increase welfare transfers, or allocate to other Government priorities.

13. While extending the taxation of capital gains would generate additional revenue, it would likely result in a higher level of volatility in revenue. The amount of revenue generated would be highly correlated with asset prices and the performance of the economy. Cyclical revenue could be supportive of economic stability (through the operation of the "automatic fiscal stabilisers") as the Budget Responsibility Rules allow for the operating balance to fluctuate over the economic cycle. However, greater revenue volatility would require disciplined fiscal management so that future Governments do not lock themselves into ongoing future expenditure commitments when revenue from taxation of capital gains is temporarily very high. We consider these risks can be managed.

Disadvantages

Creates a "lock-in" for investment decisions

14. Taxing capital gains only when they are realised creates an incentive for taxpayers to hold onto their assets for longer in order to delay the payment of tax on their gains. This

means that some economically efficient transactions that are currently occurring may cease to occur.

15. There have been many empirical studies of the significance of lock-in. While some have found that lock-in does not appear to be much of an issue in particular areas (e.g. with respect to the ownership and sale of portfolio shares), other more recent studies have found significant effects. However, it is difficult to know whether studies in one country are relevant for another because lock-in is affected by details of a country's tax provisions, including rollover relief.

16. Our view is that taxing capital gains when they are realised would create a lock-in effect, which would negatively affect economic efficiency. There are ways to reduce the negative effects of lock-in, but these are not without their own downsides. For example, rollover relief may at times remove lock-in. However, if the tax payable on capital gains is allowed to be rolled over, the size of the future capital gains tax liability will increase. This would increase the future longer-term lock-in effect, increasing the incentive not to sell the replacement asset (unless rollover were also available for that sale). Having limited rollover relief would limit the longer-term lock-in effect.

Increase in compliance costs

17. Extending the taxation of capital gains would result in an increase in compliance costs. These would be both one-off costs that would occur when the tax comes into effect, such as valuation of assets, as well as ongoing costs associated with the regime.

18. The ongoing compliance costs would mostly relate to valuation and record-keeping. Valuation issues would arise when certain assets are transferred between associated parties, or when they move in or out of the tax base. The ease of valuation would depend greatly on the type of asset: some, such as intangible property, are much more difficult to value than other assets, such as listed shares.

Increase in total taxes on investment and saving

19. Extending the taxation of capital gains would, effectively, be an increase in the taxation of savings and investment. Over a third of the additional revenue would likely come from the business sector. To the extent that this revenue reflected increased taxation of land, the impact on economic efficiency would likely be relatively limited. However, overall we would expect the higher tax burden to have a negative impact on aggregate levels of investment in the economy, which would likely flow through to lower levels of productivity.

20. Recycling revenue raised from extending the taxation of capital gains to measures that support business investment would be likely to support economic efficiency and productivity.

21. The long-term amount of revenue that is expected to be generated from extending the taxation of capital gains is relatively modest in the context of the overall size of the economy, at around 1.2% of GDP. However, the effect on some sectors and individuals could be significant.

Impact on the Housing Market

22. Extending the taxation of capital gains earned on residential property that is not a family home (discussed later in this report) could have an effect on both house prices and rents. Economic theory suggests that taxing these gains would put upward pressure on the rent-to-price ratio for residential housing. This could result in either an increase in rents, a decrease in house prices, or a combination of changes in both rents and prices.

23. There is considerable uncertainty about the effects on the housing market of extending the taxation of capital gains from residential rental property. It is expected to put some upward pressure on rents. There is more uncertainty about the effects on house prices,

although the impacts are not expected to be large in magnitude. The effects will depend partly on housing market demand/supply conditions and expectations of market participants when any policy is announced and introduced. The housing market impacts could be moderated with complementary tax policies to reduce costs for landlords and increase household incomes, discussed later in this report.

Officials' View

24. We consider that a broad extension of the taxation of capital gains (excluding the family home) would likely meet a number of the objectives in the Group's terms of reference, particularly the objectives to improve the fairness, sustainability and integrity of the tax system. It would also reduce the extent to which tax settings bias investment decisions and thereby likely lead to a more efficient allocation of capital in the economy

25. On its own, extending the taxation of capital gains is likely to have a negative impact on productivity and efficiency in the economy (as would almost any measure which raises a similar amount of tax revenue). While it would likely improve the allocation of resources in the economy, it would also increase the total level of taxation on saving and investment, create compliance costs, and introduce lock-in effects.

26. The overall effect of extending the taxation of capital gains on economic efficiency and productivity would depend on how the revenue raised is used. Using a significant portion of the revenue to make productivity-enhancing tax changes would be necessary if the goal is a tax reform package that improves New Zealand's productivity performance.

27. While there are some important downsides of a broad-based tax on more capital gains, other countries have wrestled with similar competing considerations and New Zealand is now the only member of the OECD, except for Belgium, without a formal, comprehensive regime in place for taxing the capital gains made by its personal and corporate residents.

28. High-level design details for extending the taxation of capital gains that have been considered by the Group are set out below, along with our initial high-level advice on those details.

Key Design Settings

29. The way in which a tax on capital gains is designed will have a major impact on the fairness and efficiency of the tax, compliance costs faced by taxpayers, and the effectiveness of the tax in generating revenue. The most significant design issues are discussed below. Areas where there may be some significant differences in opinion between officials and the Group are noted. We will provide you with a more detailed report on our view of the design arrived at by the Group when it delivers its final report to you.

What to tax

Scope

30. The Group's current view (as set out in its interim report) is that all of the following classes of assets should be subject to a tax on capital gains:
    a) Land (except the family home)
    b) Assets held by businesses
    c) Intangible property (all intangible property that is not currently taxed, unless it is held as a personal use asset)
    d) Shares and other equities (with specific rules for managed funds and foreign shares)

31. This would mean that tax would be collected on capital gains on almost all assets within New Zealand. The goodwill element of businesses will be captured by this list, either as

a business asset that is sold, or to the extent that goodwill is reflected in the value of a company's shares.

32. We agree that all of the assets listed above should be subject to the proposed taxation of more capital gains. Having a broad-based tax on capital gains would help ensure that the proposed tax would be both neutral, which would reduce the impact of the tax system on investment decisions, as well as fair, because taxing a broader base of capital gains is more in line with the principle of horizontal equity.

33. It is still possible to extend the taxation of capital gains to just a sub-set of the asset classes listed above. If you decided there should not be a tax on capital gains for all of the assets listed above, it would be possible to have a targeted tax that only included residential property that is not the family home. However, limiting the tax in this way would have significant implications both for the fairness of the tax (it would only apply to one form of wealth, so would not reach some that have significant wealth in assets such as closely-held companies) and for the revenue the tax would be expected to generate.

34. There are some types of assets that could be excluded from the scope of extending the taxation of capital gains. These are set out below.

Family home

35. There are a number of technical issues to work through in defining the family home. This is one area where the views of officials may differ at the margin from those of the Group, with officials tending to be more lenient than the Group mainly on the grounds of keeping compliance costs to a minimum.

Personal assets

36. In its interim report, the Group recommended that personal use assets, including cars, boats, non-business intangibles like personal insurance policies, and collectibles, including jewellery and fine art, should be outside of the base for extending the taxation of capital gains.[1] However, it also recommended that personal use land that falls outside of the family home definition should be in the base. This includes assets like second homes and baches. We agree with these recommendations.

Effective Date

37. The Group considered two possible options for how to start taxing assets after a tax on more capital gains comes into effect. One approach is to bring all gains and losses that occur from that effective date into the base (the Valuation Day approach). This would require all assets to have an assigned value from that date. The other approach is to only bring gains and losses on assets purchased after that effective date into the base (the grandparenting approach). This would allow the owners of assets acquired before the effective date of the tax to continue to make untaxed capital gains, as such assets would effectively be 'grandparented'.

38. In its interim report, the Group recommended the Valuation Day approach, and officials agree with this recommendation.

39. There is a large degree of private sector disquiet with the compliance costs associated with a Valuation Day approach. We agree that requiring all taxpayers to obtain a professional valuation as part of this process would be unreasonable. We consider there are low-compliance options that could be developed for all the major asset classes. This was also highlighted by the Group in its interim report.

40. The alternative grandparenting approach would have a significant negative impact on efficiency. It would create a substantial incentive for the owners of grandparented assets

[1] Unless such assets would currently be taxable because, for example, they were purchased with the intention of resale for a profit, or were purchased as part of a business.

to hold onto those assets for longer than would otherwise be economically efficient, in order to continue to earn untaxed capital gains. This would exacerbate the lock-in effect created by taxing capital gains on realisation.

41. This approach would also be contrary to the principle of fairness. It would mean that people who are holding similar assets would be taxed differently based on when they acquired their asset, which is contrary to the principle of horizontal equity. It is also likely that taxpayers with lower levels of income and wealth would be more likely to have to dispose of grandparented assets quicker than other taxpayers. This would mean that taxpayers with higher levels of income and wealth would be more likely to continue earning untaxed capital gains for longer than other taxpayers. This would be contrary to the principle of vertical equity.

42. From a revenue perspective, grandparenting the existing asset base would likely raise less revenue than the Valuation Day approach. We estimate that the grandparenting approach would only raise 20% of the revenue in the first five years that the Valuation Day approach would raise. This gap would lessen over time (and eventually disappear altogether) as the churn of assets brought them into the base. According to Australian Tax Office officials, Australia still has a number of grandparented assets, despite the fact that their tax has been in place for over 30 years.

43. Although the grandparenting approach avoids the compliance costs associated with requiring assets to be valued on Valuation Day, it does require complex rules prescribing when assets may lose their grandparented status. Several Australian practitioners we consulted considered that the grandparenting approach created a lot of complexity in their law.

Phasing

44. Phasing relates to whether extending the taxation of capital gains on some asset classes could be delayed or staggered.

45. The main argument for some form of phasing is that extending the taxation of capital gains for some asset classes is more complex than for others. Having phasing would allow tax to be collected on the simpler asset classes at the same time as rules around the more complex asset classes are still being developed.

46. On the other hand, the phasing of asset classes would cause considerable problems. Staggered introduction would increase compliance and administration costs, and create temporary distortions and inequities in the treatment of different asset classes. It may also require the enactment of temporary definitional rules (to identify taxable assets) that would become redundant once the other classes were also subject to tax.

47. The Group has heard submissions from the managed fund industry that it would struggle to meet a 1 April 2021 effective date for taxing capital gains made within funds. Officials do not yet have a firm view on the scale of these concerns but this is something that could be considered as part of future public consultation.

48. If the Group were to recommend some broader form of phasing this is an area where we would disagree with its recommendation.

When to tax

Realisation vs accrual

49. The Group will be recommending extending the taxation of capital gains on the basis that the tax would only be imposed when a gain or loss is realised. This will usually occur when an asset is sold, but can also occur in other cases such as assets being gifted or rendered unusable. This approach would remove the cash flow and valuation issues

associated with taxing capital gains on an accrual basis (which the Group effectively ruled out for most asset classes in its interim report).

50. We agree that taxing on realisation is a better approach than taxing on accrual.

51. There are some specific situations where taxing capital gains on realisation will not be appropriate. For example, there are significant issues with having a realisation tax on shares held by managed funds. However, the application of this tax to the managed fund industry is an issue that will require significant consultation with the industry before we can provide you with a final recommendation.

Rollover

52. There will be times when the ownership of an asset changes when it would not be appropriate to collect tax on the resulting capital gain (or loss). This is called rollover treatment.

53. Rollover treatment is not an exemption from the tax, but merely a deferral of the taxing point. When rollover treatment is granted, the tax will still be collected at some point in the future. The gains (or losses) that accrued before the rollover event are rolled over and still subject to tax at a later sale.

54. Different countries have different principles for granting rollover treatment. As a general rule, officials consider that rollover should be relatively limited, because:

- rollover treatment reduces the revenue raised from the tax, as it allows the tax to be deferred until there is a realisation event that does not qualify for rollover. This could be in many years' time or potentially many lifetimes, if rollover treatment applies to death and gifts.
- some forms of rollover treatment may negate the fairness benefits that extending the taxation of capital gains is intended to provide.
- while rollover treatment reduces lock-in for an initial realisation event, it also leads to greater lock-in issues in the long term and may bias decisions on how firms reinvest.

55. Officials are of the view that rollover should be limited to the following situations:

- *Involuntary events* – A gain on an asset can potentially be realised due to an event outside of the control of the asset owner. Examples are when the Crown uses the Public Works Act 1981 to compulsorily acquire some land, or when an asset is destroyed due to a event outside of the owner's control, resulting in insurance proceeds being received. Our view is that these specific events should result in rollover treatment for the asset owner, provided that the proceeds from the realisation are reinvested into a replacement asset.
- *Business reorganisations with same economic ownership* – This rollover treatment would apply to business transactions that result in a realisation of assets but no change in ownership in substance. An example is when a sole trader decides to incorporate their business and put all of their business assets into a company. While the legal ownership of the business assets will change, the economic ownership has not. Imposing a tax on any capital gains in this situation could prevent economically efficient business reorganisations from occurring.
- *Relationship property transfers* – This rollover is provided when assets are transferred to a person's spouse, civil union partner or de facto partner (e.g., by way of gift or when the person dies). Many of these assets would already be considered jointly owned. Similarly, rollover should apply where assets are

transferred as part of a relationship property settlement (i.e., when a marriage, civil union or de facto relationship is dissolved).

56. To the extent that the Group recommends more generous rollover, we are likely to disagree with them.

How to tax

Tax rate

57. In its interim report, the Group recommended that, if more capital gains are taxed, they should be taxed at the taxpayer's marginal rate. We agree with the Group's recommendation. Doing this would allow capital gains income to be taxed like other forms of income in the Income Tax Act 2007, as opposed to being treated as a completely separate type of income. This is in line with the principle of horizontal equity.

58. Some countries choose to tax capital gains at a lower rate than ordinary income. Our view is that doing this would significantly increase the complexity around extending the taxation of capital gains. Taxing capital gains at a concessionary rate would also remove some of the horizontal equity benefits of extending the taxation of capital gains.

59. In saying this, we recognise that there are trade-offs to consider here. The higher the rates of tax on capital gains, the greater will be the inefficiencies associated with lock-in. We consider that our internationally low top personal tax rate provides scope for extending the taxation of capital gains at full marginal tax rates.

60. To the extent that capital gains are included in the ordinary "income" concept, we would expect that to also have a bearing on a person's social policy entitlements.

Capital loss ring-fencing

61. If it is decided to extend the taxation of capital gains, there needs to be a decision on how to deal with any capital losses that arise. There are a number of options available for the treatment of losses. One approach would be to allow capital losses to offset any other income, on the basis that the distinction between "capital" gains and losses and other gains and losses is arbitrary and capital gains and losses are just like any other form of income and taxed as such. A different approach would be to generally ring-fence capital losses so that they could only be used to offset other capital gains.

62. As a general rule, the more generous the rollover treatment, the more restrictive should be the treatment of losses. This is because rollover treatment provides the potential for taxpayers to 'cherry pick' by rolling over their gains and crystallising their losses. We advised the Group that there should be a starting presumption of no loss ring-fencing for all asset classes, with exceptions made as necessary. Ring-fencing losses would reduce symmetry in the tax treatment of capital gains and losses, creating a bias towards less risky investments. Introducing such a bias would have a negative effect on economic efficiency. However, there will be some reasons why loss ring-fencing is needed for specific types of assets. For example, in the case of the disposal of listed shares and other fungible assets, where losses can be crystallised at a relatively low cost and replacement assets immediately repurchased.

63. In the event that the Group recommends generous rollover and/or a restrictive use of losses, this is another area where we would disagree with its recommendations.

64. Allowing capital losses to offset ordinary income could pose a potential fiscal risk to the Government if asset prices were to decrease. Therefore, disciplined fiscal management would be required to manage future revenue volatility. Maintaining a strong Crown balance sheet would be important to ensure revenue fluctuations could be managed.

65. One specific asset class that requires particular attention is residential rental property. The housing market is currently constrained through barriers to supply,

primarily zoning restrictions and finance for infrastructure, with relatively low interest rates also contributing to high house prices. The Government is currently tackling the barriers to supply through its Urban Growth Agenda (UGA) which, if successful, will help make the housing market more competitive and could reduce house prices (although wider economic conditions such as the interest rate outlook and immigration will be important as well). Therefore, there is a fiscal risk that if house prices were to fall, there could be relatively substantial capital losses being claimed by investors in residential rental property. Without loss ring-fencing, these losses could be offset against investors' other income after the capital losses are realised.

66. The fact that investors are generally hesitant to realise a loss (that is, to sell a property for less than what they paid for it) should reduce the size of any potential fiscal risk if house prices fall. In addition, there are specific rules that can be utilised to mitigate this fiscal risk, on which we will advise you further in due course. It is also proposed that capital losses made on second homes and residential properties held for personal use be disregarded for tax purposes (see the following section). If these measures are adopted, on balance, our view is that ring-fencing capital losses made on residential property is undesirable from a tax policy perspective.

Second homes and baches

67. Under the proposed scope for extending the taxation of capital gains, all residential property (excluding the family home) would be taxed on any capital gain. However, there is an open question regarding how to treat capital losses made on residential property that is neither the family home nor residential investment property (i.e., second homes and baches).

68. Our view is that losses on second homes (homes that are not family homes or investment properties) are generally due to personal consumption. As with other losses arising from personal consumption, we recommend that these losses not be deductible against any other income.

Capital expenditure

69. Another issue is how to treat costs incurred on improving an asset after it was purchased (capital expenditure). Our view is that it is important that all capital expenditure be deductible from the sale price. Not doing so would mean that all spending that led to an increase in the value of an asset would become taxable. This would create a significant disincentive to improve an asset, even if it would otherwise be economically efficient to do so.

70. As a general point, we consider that the treatment of capital expenditure is a critical component of the design of extending the taxation of capital gains. One of the main justifications for the tax is that it will create better neutrality between various forms of income (horizontal equity). In order to be truly equitable, taxpayers should be entitled to deduct expenditure on capital assets to the extent that it is an actual economic cost. Not allowing these deductions could result in over-taxation of capital.

Engagement with Māori

71. The Group carried out five engagement hui with Māori in October to share information about key aspects of the interim report and to gain insights into possible impacts on transactions involving Māori collectively-owned assets.

72. This process identified a number of circumstances where extending the taxation of capital gains would likely result in outcomes that may not be consistent with the policy intent of the tax, possibly warranting specific treatment. The Group's final report will identify these circumstances and indicate how they should be treated under the proposed tax changes. These circumstances include, for example, transactions relating to Māori

Freehold Land and to recovery by Māori organisations of ancestral land that has been lost as a result of historic Crown action. Crown Law Office has provided legal advice that further analysis and engagement with Māori, informed by greater clarity about the key design features of proposed changes, should occur prior to taking decisions on treatment of these circumstances. This could occur as part of the Generic Tax Policy Process.

Tax Policy and the Fiscal Strategy

73. Potential tax reform should be consistent with the Government's wider fiscal strategy – for example, ensuring there is sufficient revenue to meet the Government's spending objectives to encourage a productive, sustainable and inclusive economy.

74. Tax policy decisions impact the outlook for revenue, depending on the decisions taken. Tax revenue is currently around 28% of GDP, and forecast to increase further owing to fiscal drag.[2]

75. Extending the taxation of capital gains is projected to increase tax revenue by around 1.2% of GDP after ten years, depending on the design details. Based on our understanding of the Group's likely views on design, this proposal would indicatively generate the following revenue:

Table 1: Projected revenue from extending the taxation of capital gains ($ billion)

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Residential investment	0.18	0.45	0.71	0.96	1.2	1.4	1.7	1.9	2.1	2.4
Commercial, industrial and other property	0.09	0.22	0.36	0.49	0.63	0.77	0.90	1.0	1.2	1.3
Rural property	0.07	0.17	0.27	0.37	0.46	0.55	0.64	0.73	0.81	0.89
Domestic shares not held by managed funds	0.16	0.39	0.57	0.71	0.83	0.94	1.02	1.1	1.2	1.2
Domestic shares held by managed funds	0.10	0.11	0.13	0.15	0.17	0.19	0.22	0.25	0.29	0.34
Total	**0.59**	**1.3**	**2.0**	**2.7**	**3.3**	**3.9**	**4.5**	**5.0**	**5.6**	**6.2**
% of GDP	*0.2%*	*0.4%*	*0.5%*	*0.7%*	*0.8%*	*0.9%*	*1.0%*	*1.1%*	*1.1%*	*1.2%*
% of total tax revenue	0.6%	1.3%	1.8%	2.4%	2.8%	3.2%	3.5%	3.7%	4.0%	4.3%

76. These projections of tax revenue are preliminary and indicative. Officials are continuing to refine the projections, and these numbers could be different by the time of Budget decision making. Our current expectation is that the net result of refinements to these projections will see overall downward revisions because of new data that has become available in the last week.

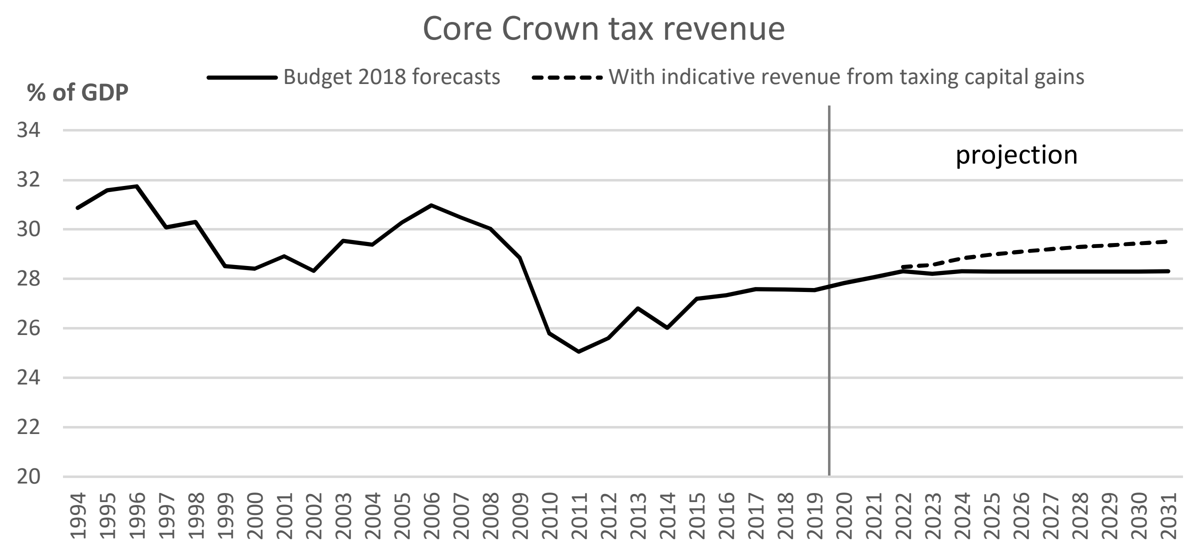
77. In addition, the projections are more uncertain than most other revenue projections because they depend heavily on assumptions about future movements in asset prices.

[2] In HYEFU, core Crown tax revenue is forecast to increase from 27.9% of GDP in 2017/18 to 28.9% in 2022/23. The rising tax-to-GDP ratio is largely driven by fiscal drag.

Actual revenue from extending the taxation of capital gains is likely to be volatile, with some periods having greater than projected revenue, while others could have less. There may be periods in which extending the taxation of capital gains could be revenue-negative, such as in an economic downturn. This inherent volatility in the revenue stream would require strong fiscal management to ensure additional revenue generated in periods when asset prices increase rapidly is set aside for the periods when asset prices fall.

78. That said, the total amount of expected revenue from extending the taxation of capital gains is relatively modest relative to GDP and total tax revenue. Figure 2 below shows a comparison between current projected tax revenue and projected revenue if more capital gains are taxed (with no offsetting tax reductions). The fiscal projections include a technical assumption that there is no fiscal drag in the projection period (beyond the five-year forecast horizon). However, if income tax thresholds are not adjusted, fiscal drag would add an additional $0.4 billion to $0.6 billion to revenue in each year.

Figure 2:



Source: The Treasury

Note: The projection of revenue from taxing capital gains is preliminary and indicative. Projections of core Crown tax revenue are based on the Budget 2018 Fiscal Strategy Report. From 2022/23, the fiscal projections assume that tax revenue is held constant as a share of GDP (ie, no fiscal drag). However, if income tax thresholds are not adjusted in the future, tax revenue would continue to increase as a share of GDP throughout the projection period.

79. The fiscal parameters of any tax reform package could be revenue-neutral, fiscally-neutral, or revenue-positive to enable higher spending in other areas. These options are discussed below.

80. Over time, the tax-to-GDP ratio would increase with fiscal drag, and therefore a revenue-negative package could also be considered as an option to stabilise the tax-to-GDP option, depending on your priorities.

81. Your views on the fiscal parameters for a package would help officials to provide advice on package options. Final decisions for a Budget 2019 package would be needed in March to take a proposal to Cabinet in early April. By March, you will have information about the updated fiscal outlook, the final reports of the Group and the WEAG, and a clearer sight of other expenditure bids being considered at Budget 2019.

Revenue-Neutral Package

82. Under a revenue-neutral tax package, all the revenue from extending the taxation of capital gains would be recycled into revenue-negative tax measures.

83. There are choices about how "revenue-neutral" is defined. The focus should be on ensuring that policy decisions are consistent with your overall fiscal objectives (i.e., the Budget Responsibility Rules).

84. Under the Group's definition of revenue-neutral, the total revenue generated from extending the taxation of capital gains in the first five tax years (2021/22 to 2025/26) roughly matches the total cost of the revenue-negative tax measures over that same period. Since the revenue from extending the taxation of capital gains increases over time, the packages being considered by the Group are typically revenue negative in the early years. They would therefore be revenue negative over the Budget 2019 forecast period (2018/19 to 2022/23).

Fiscally-Neutral Package

85. Depending on the Government's overall priorities, revenue could be used for a combination of revenue-negative tax, transfer or other expenditure initiatives.

86. There are different types of potential fiscally-neutral packages. One option is a fiscally neutral tax-and-welfare package, in which the revenue from extending the taxation of capital gains would be recycled into a combination of revenue-negative tax and welfare measures (welfare measures could include benefits and Working for Families tax credits). Higher tax revenue would help meet the fiscal costs of large welfare changes and considering personal tax and welfare changes together would improve policy outcomes (as personal tax and welfare systems interact).

87. There are options for sequencing tax and welfare decisions. One option would be to make decisions on welfare changes at the same time as decisions on extending the taxation of capital gains and introducing other revenue-negative measures. Changes to payment rates for existing benefits and/or tax credits could be considered in Budget 2019 because they do not require changes to primary legislation. The Ministry of Social Development is progressing three Welfare Overhaul initiatives for Budget 2019. However, there would be no time to develop an integrated reform of the tax-welfare interface in time for Budget 2019 that involved significant changes to the underlying settings of the welfare system such as changing eligibility settings.

88. Therefore, an alternative option would be to earmark a set amount of the revenue from extending the taxation of capital gains to put towards a future personal tax and transfer package. This approach would provide the Government with flexibility as to the timing of these decisions, while still ensuring that some of the revenue generated from extending the taxation of capital gains would go towards supporting low-income individuals. This option is not mutually exclusive from making some specific changes to welfare payments in Budget 2019. You could make some changes at Budget, while earmarking an additional amount for future welfare changes.

89. Once passed, the Child Poverty Reduction Bill will require the Minister of Finance to announce at Budget the impact of changes on child poverty. Changes to personal thresholds will not lift incomes of beneficiaries who are not in work, because tax changes do not lead to an automatic adjustment of benefits (as they do for New Zealand Superannuation and Student Allowance rates). Consequently, changes to personal taxation thresholds alone may not have any material impact on measures of child poverty, and for out-of-work families it could move them further away from the moving child poverty line, as the net median income rises. With an integrated tax and welfare

package you could consider the balance of impacts across poverty reduction, work incentives and fairness of the tax system at the same time.

Revenue-Positive Package

90. Under a revenue-positive package, a portion of revenue from extending the taxation of capital gains could be recycled into some near-term revenue-negative measures, but the remainder of the revenue would be left unallocated. This would provide more time and greater flexibility to consider the best way to use the expected revenue through the Budget process or pay down debt. This may be desirable given the time needed to consult, finalise and implement policy on extending the taxation of capital gains.

Revenue-Negative Measures

91. The Group is considering a range of revenue-negative measures as part of a tax reform package. The total cost of the measures exceeds the revenue from extending the taxation of capital gains. Therefore, the measures would need to be prioritised based on the Government's objectives to create a revenue-neutral package.

92. Below, we provide you with our initial high-level advice on the revenue-negative measures being considered by the Group, and other measures that could be considered. The measures are split into three categories:

    a) personal income tax or transfer options that focus on distributional objectives
    b) business and housing measures that focus on improving productivity and efficiency, and
    c) KiwiSaver measures that support low-income savers and which should more than compensate for the impact on them of extending the taxation of capital gains.

93. The indicative fiscal impacts of the measures below are based on assumptions about specific design features for the measures. Since there are a range of potential design alternatives for most of the measures, the fiscal impacts will change depending on the design choices made. In addition, officials will undertake further quality assurance of the final costings, which may change the results, and so they should be considered as indicative only. Many of these revenue estimates do not take into account wider economic or behavioural effects.

Personal income tax/transfers

94. The Group has considered personal tax changes that would increase the progressivity of the tax scale consistent with the Government's objectives outlined in your letter to the Group of 20 September. The Group has noted that transfers may be a more targeted tool to achieve the Government's objectives, but these are outside its terms of reference.

s9(2)(f)(iv)

[redacted]

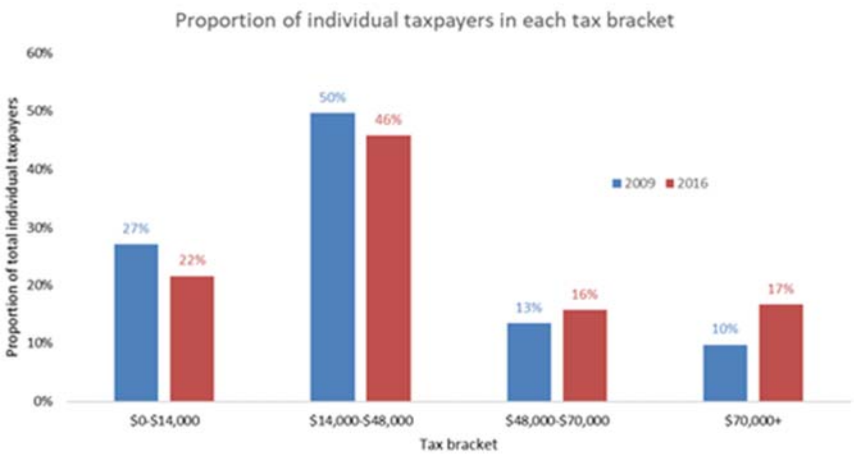
s9(2)(f)(iv)

Changes to other tax thresholds and/or rates

101. The Group has not focused on personal income tax settings at middle-to-upper income levels, but the Government could consider options here to support its objectives. Over time, more earners will move into higher tax brackets if personal income tax settings are not adjusted. Changes to middle and upper personal tax settings could support economic performance by affecting incentives to work, save, acquire skills and invest. More analysis would be required if you are interested in further advice on these options.

102. Figure 3 below illustrates how a greater percentage of taxpayers moved into the top two tax brackets since 2009.

Figure 3:



Welfare transfers

103. As the Group has noted, one option would be for a package to include a combination of tax and welfare transfer measures.

104. Both taxes and transfers are important for achieving distributional objectives. However, transfers can be targeted much more tightly to those with very low taxable incomes or particular needs (e.g., families with children).

105. Of the three Welfare Overhaul changes being considered for Budget 2019, two target sole parent beneficiaries, and include removing a sanction and allowing the passing-on

of child support. The third targets in-work beneficiaries, and proposes increasing abatement thresholds for main benefits.

106. There are a range of other measures that could be considered in the welfare space, including increasing the level of benefits and/or the accommodation supplement. To provide a sense of the size of significant welfare reform, s9(2)(f)(iv) [redacted]
s9(2)(f)(iv) [redacted]

107. The nature of any welfare component to a package should depend on the Government's specific objectives. The WEAG's final report may outline an approach to broader welfare reform and is expected to be sent to the Government in February.

Interaction between the tax and welfare systems

108. In designing a package, it would be necessary to consider how any personal income tax or welfare measures would interact with the current tax and transfer system. In particular, the effect that any change in tax thresholds would have on the abatement of some existing welfare measures would need to be managed to ensure that any changes did not result in unreasonably high effective marginal tax rates (EMTRs) for people receiving some benefits. This is something we can provide more detailed analysis on if you are interested in particular tax or welfare measures.

109. Comprehensive reform of the tax and welfare interface would be complex. In order to ensure that the interaction between the tax and welfare systems is fully taken into account, we would recommend that any decisions regarding personal tax and welfare measures be delayed until after Budget 2019. This would allow for the WEAG's conclusions to be fully taken into account before any measures are decided on, while also providing time to ensure that any measures that are implemented complement each other.

Business and Housing Measures

110. As noted earlier in this report, extending the taxation of capital gains would, on its own, be likely to have a negative impact on economic efficiency and productivity. The overall effects would depend on how the revenue is used. The Group has considered the following productivity-enhancing tax changes. In our view, these should all be part of a package if the tax reform is to support the efficiency and productivity objectives outlined in the Group's terms of reference:

a) restoring depreciation on buildings
b) expanding black hole expense deductibility, and
c) reducing restrictions on loss carry-forwards when a company is sold

111. In addition, removing residential rental loss ring fencing should contribute to the efficiency of extending the taxation of capital gains and reduce upwards pressure on rents. We comment on these measures below along with our high-level views on reducing the company tax rate as an alternative productivity-enhancing measure.

Restoring depreciation on buildings

s9(2)(f)(iv) [redacted]

Note: Page 23 has been removed under section 9(2)(f)(iv) OIA

s9(2)(f)(iv)

[redacted]

118. [redacted]

119. [redacted]

120. [redacted]

121. [redacted]

122. [redacted]

123. [redacted]

Depreciation for seismic strengthening costs

s9(2)(f)(iv)

124. [redacted]

125. [redacted]

126. [redacted]

127. [redacted]

Expanding black hole expense deductibility

128. Black hole expenditure is business expenditure that is expected to result in an economic cost to a taxpayer, but is neither immediately deductible for tax purposes, nor deductible over time.

129. The Group is considering a measure that would expand the situations when black hole expenditure would be deductible. This measure is estimated to cost around $120 million over five years.

130. s9(2)(f)(iv) [redacted]

131. [redacted]

Reducing restrictions on loss carry-forwards when a company is sold

132. Currently, tax rules restrict the carrying forward of any losses incurred by a company if the ownership of the company changes by more than 51%. This can create an impediment on small businesses that have made losses in the early years, but are looking to expand.

133. s9(2)(f)(iv) [redacted]

134. [redacted]

135. [redacted]

Removing rental loss ring-fencing

136. One of the main rationales for removing rental loss ring-fencing was the lack of a comprehensive tax on capital gains made by landlords. This justification for loss ring-fencing would be removed if the gains on residential housing were taxed.

137. While there could still be some timing benefits, because gains would still only be taxed when realised, this is a general issue with taxing realised gains and there is no clear reason for special treatment of residential rental property over other capital assets. It is likely to lead to greater tax on debt-financed than equity-financed investment in rental property. Removing loss ring-fencing on rental property could also have potential benefits for improving housing supply and reducing pressure on rents, which would help to offset the potential upward pressure on rents from taxing capital gains.

138. This measure is estimated to cost around $1.3 billion over five years.

s9(2)(f)(iv)

[redacted]

KiwiSaver Measures

147. Extending the taxation of capital gains would result in savers, including those who save using KiwiSaver, facing a larger tax burden. Below we summarise three measures considered by the Group:

a) decreasing lower KiwiSaver PIE rates
b) removing tax on employer contributions to low-income KiwiSavers, and
c) increasing the Member Tax Credit (MTC) for all KiwiSavers.

148. All of these measures would have an impact for low-income KiwiSavers by providing additional subsidies, but may not generate much additional saving (in addition to the

subsidies). In addition, they only support those low-income earners who are able to save. They are unlikely to have a significant impact on aggregate private saving. If the Government's objective is to support lower income households more generally, changes to the tax and welfare settings would likely be more effective than these KiwiSaver measures.

149. The KiwiSaver measures consider by the Group should also be viewed in light of the Treasury's recent advice on improving retirement outcomes by increasing enrolments in and contributions to KiwiSaver (T2018/3417 refers).

Decreasing lower KiwiSaver PIE rates

150. Currently, taxpayers in the top tax bracket of 33% only pay 28% in tax on income earned in their KiwiSaver PIE funds. In contrast, taxpayers earning less than $48,000 generally pay tax on income earned in their KiwiSaver PIEs at a rate that is the same as their marginal tax rate. This can be argued to be unfair as it reduces the progressivity of the tax system.

151. In its interim report, the Group recommended that all lower PIE tax rates be reduced for KiwiSaver funds to match the 5% saving that taxpayers in the top threshold already receive. This measure would provide targeted support for low-income savers.

152. This measure is estimated to cost around $630 million over five years.

Removing Tax on Employer Contributions to Low-Income KiwiSavers

153. The Group also made a recommendation in its interim report to remove the employer superannuation contribution tax (ESCT) for low-income individuals putting money into KiwiSaver. This measure would also provide some targeted support to low-income savers.

154. The measure would not apply to any individual who earns over $48,000. This effectively creates a "fiscal cliff" for taxpayers who earn close to that amount. The Group has since considered an alternative measure that would see the removal of ESCT abate at a rate of six cents for every dollar earned over $48,000. This removes the fiscal cliff problem, but does lead to a higher fiscal cost.

155. This measure is estimated to cost between $960 million and $1.7 billion over five years, depending on how the measure is designed to deal with the abatement issue.

156. We do not consider that this measure would be effective in increasing member contributions. It is an opaque way of providing a benefit to low-income savers (surveys showed that most KiwiSaver members were not aware of ESCT relief benefits when they applied earlier). It would also impose additional compliance costs on business and administration costs on Inland Revenue. Our initial view is that reducing lower KiwiSaver PIE rates would be a better measure.

Increasing the Member Tax Credit

157. The Group has considered increasing the Member Tax Credit (MTC) contribution that the Government makes to individuals investing via KiwiSaver schemes. The proposal being considered is to increase the contribution from $0.50 for every dollar invested (up to a cap of $1,042.86), to $0.75 for every dollar invested. This measure is estimated to cost around $2.5 billion over five years.

158. The proposal would not increase the amount that individuals would need to save in order to receive the full MTC. Instead, it would simply increase the total contribution that individuals would receive for investing $1,042.86 into KiwiSaver, from $521.43 to $782.15 (an increase of $260.72 per year).

159. We consider that increasing the MTC would not have a significant impact on encouraging new savings (beyond the direct increase resulting from the Government's injection). While increasing the rate of the MTC to $0.75 may incentivise some individuals to enter into KiwiSaver who are not currently saving, this number is likely to be small. The current MTC of $0.50 for every dollar invested is already a significant return compared to other savings options. Most of the benefit of this measure would go to savers who are already contributing at least $1,042.86.

160. The Group is also considering a measure that would give the full MTC to primary caregivers in the first year that their child is born. This would ensure that the KiwiSaver savings of primary caregivers continues to increase while they are not in paid work. This would reduce the negative impact that taking time off work to care for a new child can have on an individual's lifetime savings. This measure is estimated to cost around $60 million over five years.

Summary of Officials' Views

161. Officials would support extending the taxation of capital gains if implemented as a package with other complementary measures. We consider that a broad extension of the taxation of capital gains (excluding the family home) would likely meet a number of the objectives in the Group's terms of reference, particularly the objectives to improve the fairness, sustainability and integrity of the tax system. It would also reduce the extent to which tax settings bias investment decisions, and thereby likely lead to a more efficient allocation of capital in the economy.

162. In order to address the efficiency and productivity objectives outlined in the Group's terms of reference, extending the taxation of capital gains would need to be part of a package including measures to support business investment and productivity.

163. Of the measures considered by the Group, we would recommend those outlined in the table below. These measures would all address significant inefficiencies in the structure of the tax system that are currently acting (or would act) to bias decisions.

164. We would recommend measures 2 to 4 whether or not the Government was considering extending the taxation of capital gains (subject to revenue constraints). However, they would also be an important business offset for extending the taxation of capital gains. In respect of measure 5, the case for residential loss ring-fencing, in particular, is much reduced if capital gains are taxed more broadly.

Policy measure	Rationale	Indicative 5-year revenue impact (from 2021/22)
1. Extending income tax to include realised capital gains (excluding the family home)	Increase fairness, sustainability and integrity of the tax system	+$10 billion
2. Allow businesses to claim depreciation expenses on buildings	Encourage more business investment and improve efficiency of investment	s9(2)(f)(iv)
3. Allow businesses to deduct expenses for "black hole" expenditure	Encourage innovation and entrepreneurship	-$0.12 billion
4. Allow businesses to keep losses when the owner changes	Make it easier for small companies to expand	-$0.24 billion
5. Remove residential rental loss ring-fencing	Recognising that gains would be taxed, this would reduce upward pressure on rents and increase efficiency	-$1.3 billion (preliminary estimate, likely to be lower)

Note: These fiscal estimates are highly uncertain, preliminary, indicative, and are subject to further refinement. Projected revenue from extending the taxation of capital gains is likely to be revised downward because of new data that has become available in the last week. The revenue would build up slowly over time and be volatile.

165. We consider that a package with these core elements would be cohesive and effective in contributing to the Government's overall objectives for the tax system. This package would:

- make the tax system significantly more progressive
- increase fairness through a more consistent taxation of capital income (horizontal equity)
- improve revenue integrity and sustainability
- increase incentives to develop land for productive purposes, and
- improve business tax to better support investment, innovation and productive risk-taking.

166. The above core package would leave room for remaining revenue to be used for other priorities. We would expect the above revenue-negative measures to have a revenue cost of around a third to a half of the revenue raised from extending the taxation of capital gains over the first five years. Depending on the Government's overall priorities, the remaining revenue could be used for other revenue-negative tax measures, expenditure initiatives, reducing debt, or setting aside for future Budget decisions.

167. The Government could announce personal tax or some welfare measures at Budget 2019. However, officials would recommend delaying design decisions on personal tax and welfare settings until after Budget 2019. Deferring decisions would enable time to take account of the WEAG's recommendations and provide the necessary time to develop an integrated personal tax and welfare reform package.

Next Steps

Timeline for Legislation

168. A number of submissions on the Group's interim report noted concern with the publicly available timeframes indicated for the generic tax policy process (GTPP) and legislative process beyond its final report. The Group requested officials' advice on this process.

169. Our advice was that, if Cabinet decides it wants to enact legislation before the 2020 General Election to extend the taxation of capital gains, legislation would need to be introduced by November 2019. Before this, there would need to be a consultation on detailed design decisions, which would need to start around May 2019 with the release of a Government discussion document.

170. We noted that this timeline does not leave much time for detailed design decisions to be made. As noted throughout this report, there are a number of complex design decisions that will need to be made before legislation can be introduced. This report has only touched on the high-level design decisions. There are many other complex issues associated with extending the taxation of capital gains that we have yet to discuss with you.

171. There is a risk that rushing consultation undermines the GTPP. Under GTPP, changes to tax policy are supposed to go through a process of consultation with the general public, including the private sector. One of the main goals of GTPP is to ensure that all policy issues that have a significant impact on the public are considered by officials before legislation is drafted. Consultation on the policy issues before legislation is introduced allows consultation after legislation is introduced to focus on how well the legislation actually implements the Government's policy decisions, rather than on issues with the policy itself.

172. More time being built into this process would ensure that, through adequate consultation, legislation is fit for purpose, well-understood, well-tested to ensure that it achieves the Government's objectives, and workable. This would minimise the need for further legislative change in the future.

173. Legislation that requires substantial amendment post-enactment increases uncertainty and can impose significant compliance costs on taxpayers, who may have to update their processes in response to changes in the way that the tax operates.

174. We have advised the Group that we consider including all legislation in one Bill is preferable to splitting it over multiple Bills, as this provides a better opportunity to achieve a coherent and sustainable change to the tax system. It would also eliminate the need for temporary measures that may be necessary to enforce boundaries that would exist in the short term but not once all relevant asset classes were subject to tax.

175. In saying this, officials can meet the proposed timeline. However, because of the risks involved, our recommendation is that the timeline be amended to allow legislation to be introduced in the middle of 2020 with an effective date of 1 April 2022.

176. Finally, extending the taxation of capital gains would require considerable IT changes within Inland Revenue, and preparation to assist taxpayers with implementation and ongoing compliance (for example, information, education and relevant forms). This means, particularly if the effective date of 1 April 2021 is retained, Inland Revenue will need to incur significant implementation costs through 2019-21.

Process for further advice

177. The Group is expected to send you its final report in late January 2019. Officials will provide you with a report at the same time setting out where we agree and disagree with the Group's final recommendations.

178. In order for the Government's response to the final report to be included in Budget 2019, you will need to make final policy decisions in March, and take papers to Cabinet in April.

179. To help facilitate the making of these decisions, we propose sending you a series of reports seeking your provisional decisions on both the design choices for extending the taxation of capital gains, and on how the revenue raised could be allocated. These reports would be sent to you throughout late January and February. The topics covered in these detailed reports can be based on your feedback on this report.

180. We suggest no final decisions be made until March, once you have had the opportunity to consider these additional reports.

181. After final decisions are made, we propose preparing a paper for Cabinet to consider, as well as a discussion document on extending the taxation of capital gains that could be released at Budget 2019.

182. We also propose preparing material for a series of workshops with your Ministerial colleagues on the Group's final report. These workshops would be of a similar nature to the workshops carried out prior to the Group's interim report going to Cabinet. Subject to your approval, officials can liaise further with your offices on the timing and content of these workshops.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Inclusion of asset groups in a capital gains tax

Date:	14 December 2018	**Priority:**	Medium
Security level:	Sensitive - Budget	**Report number:**	IR2018/803 T2018/3721

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	None
Minister of Revenue	**Note** the contents of this report	None

Contact for telephone discussion (if required)

Name	Position	Telephone
Mark Vink	Manager, Tax Strategy, the Treasury	s9(2)(a)
Phil Whittington	Senior Policy Advisor, Inland Revenue	
Steve Mack	Principal Advisor	

14 December 2018

Minister of Finance
Minister of Revenue

Analysis

1. This report responds to your request for information on the following:

    - pros and cons of staggering application to different assets,
    - pros and cons of excluding business assets from the base; and
    - pros and cons of excluding baches from the base.

2. The report has been pulled together quickly and we have not had time to consider the issues in depth. We can provide a more considered and detailed response if required.

Staggering application

3. The Tax Working Group (the Group) have looked at a capital gains tax that applies to the following asset classes:

    - Land and buildings (including holiday homes)
    - Shares
    - Intangible property held for business or investment purposes
    - Business and investment assets

4. The following assets are excluded from the Group's proposal:

    - Family home and the land under it
    - Personal use assets (e.g. cars, boats, jewellery, art)

5. We understand that the indicative timetable the Government is working to is:

    - Tax Working Group report released by the Government in February 2019;
    - A discussion document released on Budget day 2019;
    - A bill introduced in Parliament in October or November 2019;
    - Bill enacted before the next election (expected to be in late 2020); and
    - New law to take effect from 1 April 2021.

6. Officials consider this timetable is challenging but achievable. However, there will be risks of insufficient consultation and drafting errors in the legislation due to the short timeframe for policy development and drafting. There is also a concern that rushed legislation may lead to ongoing legislative change and this could add to compliance costs. It may be especially difficult for managed funds to meet the timetable as they have advised it would require significant systems changes.

7. One option to reduce this risk is to delay the entire process and aim for a start date of 1 April 2022.

8. You have asked if it is possible that some aspects of the regime come into effect before other aspects. Officials' recommendation is that the regime come into effect at the same time for all asset categories, either on 1 April 2021, or 1 April 2022. We see the following as the key pros and cons of staggered application:

9. Pros of staggering application are:

- The easiest aspects of the regime could be enacted quickly and start raising revenue. An example could be residential investment property, as it is already subject to the five-year bright-line test (although some aspects of this may need to be changed, such as the approach of exemptions and rollovers and family home issues);
- Some of the more difficult aspects of the regime could be given more time for consultation and development. These include application of business assets to rollovers, the treatment of corporate groups, and application of the regime to managed funds.

10. Cons of staggering include:

- The benefits of taxing capital gains more comprehensively will be delayed, including revenues, horizontal equity and vertical equity benefits. Forecast estimates show that after five years including land used for business purposes in the base would raise up to 50% more revenue compared to taxing only personal investment assets;
- Temporary boundary issues and related rules that would not be needed once the regime applied more widely. For example, if there is an intention that the regime apply first to residential investment property but not to shares in closely-held companies, then that intention could be defeated if the property is held in a company which could be sold by selling the shares. While there is a bright-line anti-avoidance rule that can easily be adapted to make a sale of any residential property-owning company taxable, those rules would no longer be necessary when the sale of shares in controlled companies became taxable;
- Public perceptions of fairness could be undermined if the regime applies first to fairly commonly-owned assets, such as residential investment property; but not assets such as shares in controlled companies, which may be owned by wealthier owners.;
- A risk that the full regime is never implemented, due to changing Government priorities and reducing marginal gains from incremental extensions.

11. Overall, officials consider the advantages of staggering are outweighed by its disadvantages. In particular, we consider the complexity and integrity costs that would be associated with the boundary issues created by staggering would be likely greater than the benefits of having more time to develop the phased aspects of the regime.

Application to different types of assets

Investment assets

12. Investment assets include residential investment property and could include other forms of real property held for passive rental. For the purposes of the revenue estimates we assume all commercial, rural, and industrial land is treated as business assets even if owned for rental.

Business assets

13. Business assets include the assets of an active business, such as real property used in farming or industry, business goodwill, shares of subsidiaries in a corporate group, and shares of a controlled company.

14. Pros of excluding business assets from the tax base include:

- Simplicity, especially from the exclusion of subsidiaries in a corporate group and less pressure for rollovers. The complexity from subsidiaries arises from trying to ensure there is as little double tax or double deductions as possible.
- No need to value goodwill on valuation date

15. Cons of excluding business assets from the tax base include:

- Less revenue;
- Reduced integrity protection if the sale of shares in a controlled company is not taxed, as that helps reduce the effectiveness of schemes to avoid dividend taxation;
- The regime would be less progressive because gains on the sale of controlled companies can be a source of very large gains

16. There are possible intermediate options. For example, it is possible to exclude active business assets generally but still tax the gain on the sale of controlled companies for the benefits of integrity and progressivity (although that would mostly remove the advantage of not needing to value goodwill).

Baches (second homes)

17. By baches we are referring to residential property that is not the owner's excluded family home, and is not residential investment property, but is occupied by the owner and family temporarily as a second home or holiday home.

18. Pros of excluding baches from the tax base include:

- The Working Group has proposed that gains on baches should be taxable but losses should not be deductible. This has some merit under tax policy principles as losses on assets which generate consumption benefits are not deductible. For example, a business owner can only claim deductions for expenses incurred in producing income and not for consumption expenses. It may, however be a communications challenge for the Government to explain why they are taxing the gains but not allowing a deduction for losses;

- Reduces compliance and record-keeping costs for bach owners.

19. Cons of excluding baches from the tax base include:

- Reduced revenue (estimated $200 million in the first five years);

- Progressivity;

- Baches are currently taxable under the five-year brightline, so exempting them could be a reduction from the current tax base (unless the brightline is retained just for baches).

- Taxing the gain on residential investment property but not baches creates a perverse incentive for the owner to keep the bach vacant when they are not using it, rather than make it available for others to tenant;

- Baches are often rented temporarily when the owner is not using them. If we tax the gain on residential investment property but not baches, then it would create boundary and apportionment issues of whether the gain is taxable, or how much of the gain should be taxable.

- Taxing residential investment property but not baches may require integrity rules to ensure that owners of baches that have gone down in value cannot retrospectively classify them as residential investment properties to get a tax loss.

Financial implications

20. The following tables show forecast revenues from applying the regime just to investment assets (including rental property, baches and shares), and then to business assets. It shows that gains on business assets (assumed to be land used for business purposes) would raise more than 50% more revenue compared to taxing only gains from personal investment assets. This includes forecasting the estimated impact of the small business rollover proposed by the Working Group. We consider the revenue gains from taxing business assets are likely to be understated as there is no data on gains in intangible business assets such as goodwill or capital gains generated through the labour efforts of the owners of businesses, e.g., through renovating properties or building up client lists.

21. If some assets are excluded from being taxed at the company level, but gains are taxed at the shareholder level, then there will likely be some significant recapture of gains which would reduce the fiscal cost of excluding assets from taxation at the company level.

The offset would be reduced to the extent that:

- the payment of tax is deferred until shares are sold
- companies are owned by non-residents (non-residents would not be taxed on share gains).

We have not had time to cost this offset.

Table 1: Projected revenue from taxing more capital gains on investment assets ($ billion)

Year	2021/22	2022/23	2023/24	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Residential investment	0.18	0.45	0.71	0.96	1.2	1.4	1.7	1.9	2.1	2.4
Baches	0.01	0.03	0.04	0.05	0.07	0.08	0.09	0.11	0.12	0.13
Domestic shares not held by managed funds	0.16	0.39	0.57	0.71	0.83	0.94	1.02	1.1	1.2	1.2
Domestic shares held by managed funds	0.10	0.11	0.13	0.15	0.17	0.19	0.22	0.25	0.29	0.34
Total	0.45	0.98	1.45	1.87	2.27	2.61	3.03	3.36	3.71	4.07
% of GDP	0.13%	0.27%	0.38%	0.47%	0.55%	0.61%	0.66%	0.71%	0.75%	0.79%
% of total tax revenue	0.44%	0.90%	1.28%	1.59%	1.85%	2.06%	2.24%	2.41%	2.55%	2.68%

Table 2: Projected revenue from taxing more capital gains on business assets ($ billion)

Year	2021/22	2022/23	2023/24	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Commercial, industrial and other property	0.09	0.22	0.36	0.49	0.63	0.77	0.9	1	1.2	1.3
Rural property	0.07	0.17	0.27	0.37	0.46	0.55	0.64	0.73	0.81	0.89
Total	0.16	0.39	0.63	0.86	1.09	1.32	1.54	1.73	2.01	2.19
% of GDP	0.04%	0.11%	0.16%	0.22%	0.26%	0.30%	0.34%	0.37%	0.40%	0.43%
% of total tax revenue	0.15%	0.36%	0.56%	0.73%	0.88%	1.02%	1.15%	1.27%	1.37%	1.47%

22. The estimates are preliminary and uncertain and subject to change. In particular, officials are reviewing the accuracy of the turnover assumption used in costing and this could result in a reduction of revenues forecast in the real property categories.

Next steps

23. Officials will discuss this with you at your meeting on Monday 17 December.

Recommended action

We recommend that you **note** the contents of this report.

Noted

Noted

s9(2)(k)

[redacted]

Mark Vink
Manager, Tax Strategy
The Treasury

Phil Whittington
Senior Policy Advisor
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2018

Hon Stuart Nash
Minister of Revenue
/ /2018

POLICY AND STRATEGY

Tax policy report:	**Extending the taxation of capital gains: response to Ministers' requests on business impacts**

Date:	11 January 2019	**Priority:**	Medium
Security level:	Sensitive	**Report number:**	IR2019/015 T2019/18

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report **Discuss** with officials	15 January 2019
Minister of Revenue	**Note** the contents of this report **Discuss** with officials	15 January 2019

Contact for telephone discussion (if required)

Name	Position	Telephone
Emma Grigg	Policy Director, Inland Revenue	s9(2)(a)
Matt Benge	Chief Economist, Inland Revenue	
Mark Vink	Manager, the Treasury	

11 January 2019

Minister of Finance
Minister of Revenue

Extending the taxation of capital gains on business: response to Ministers' requests on business impacts

Executive summary

1. At our meeting on 17 December 2018, you requested information on the following:

   - Tax-free thresholds or exemptions for small business owners from a capital gains tax (e.g., a lifetime threshold exemption or retirement exemption);
   - s9(2)(f)(iv) [redacted]
   - Options to reduce valuation costs for businesses if a Valuation Day approach is adopted in extending the taxation of capital gains.

Tax-free thresholds or exemptions for small business owners

2. Tax-free thresholds and exemptions are used by some countries such as Australia, Canada and South Africa to provide concessional tax treatment of capital gains for small business owners. In Australia and South Africa, these provisions are linked to retirement, while in Canada they are 'lifetime exemptions'. Other countries, such as the UK and US, do not have retirement or lifetime exemptions for small business owners.

3. The Tax Working Group is likely to recommend a one-off retirement concession where the first $500,000 of capital gains derived from a closely-held active business may be taxed at reduced KiwiSaver PIE tax rates rather than personal tax rates. This is less concessionary than other countries, particularly Australia, as the capital gains are still subject to tax (albeit at a lower rate) rather than exempt. However, the tax treatment of retirement savings is generally more concessionary in Australia than New Zealand. Therefore, the Australian exemptions should be less distortionary than they would be in a New Zealand context.

4. We consider that while there may be some benefits in providing a concession for small business owners, these are outweighed by a number of other considerations including equity, efficiency, integrity and fiscal matters. If the Government wishes to reduce the impact on small businesses of extending the taxation of capital gains, we would suggest considering other measures including compliance cost savings measures proposed by the Group (e.g., lifting the threshold for automatically deductible legal expenditure from $10,000 to $20,000), or other business tax measures such as lifting the threshold for low value asset write-offs (currently $500).

s9(2)(f)(iv) [redacted]

6. s9(2)(f)(iv) [redacted]

Valuation costs for businesses

7. Like Ministers, the Tax Working Group has been cognisant of striking a balance between accurate valuations and reasonable compliance costs for taxpayers in valuing their assets. Officials are considering a range of valuation methods taxpayers could use to value their businesses to help reduce compliance costs. Some business owners may wish to get their businesses professionally valued. However, alternative low cost options could be made available, such as (a) straight-line valuation; (b) using the values from existing accounting standards; and (c) valuation proxies that have been adopted by other countries transitioning into the taxation of capital gains.

Updated revenue estimate

8. Officials have revised down the projected revenue from taxing capital gains more comprehensively. Officials previously provided an estimate that taxing capital gains would raise approximately $10 billion over the first five years following introduction (T2018/3348, IR2018/763 refers). The estimated revenue is now $8.3 billion over the five years.

9. The revised estimate is a result of additional information received by officials and refinement of the modelling approach. The estimate is still higher than the revenue estimate provided in the Tax Working Group's interim report ($7.7 billion over the first five years).

Next steps

10. We propose to discuss the contents of this report with you at our meeting of Tuesday 15 January 2019.

11. We are preparing a comprehensive briefing report for 29 January 2019 covering all the Tax Working Group's recommendations in their final report.

Recommended action

We recommend that you:

12. **Note** the contents of this report.

    Noted Noted

13. **Agree** to discuss the contents of this report with officials on Tuesday 15 January 2019.

    Agreed/Not agreed Agreed/Not agreed

Mark Vink
Manager
The Treasury

Emma Grigg
Policy Director
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Background

14. The Tax Working Group (hereafter referred to as the Group) will provide its final report to the Government in late January 2019. To help prepare you for the decision-making process that will follow the final report, we provided you with our joint report of 14 December 2018 (T2018/3429, IR 2018/800 refers) outlining our initial advice on potential tax reforms.

15. At the meeting on 17 December 2018 to discuss the joint report of 14 December 2018, you requested information on the following:

    - Tax-free thresholds or exemptions for small business owners from a capital gains tax (e.g., a lifetime threshold exemption or retirement exemption), similar to what has been adopted in some countries such as Australia and Canada.
    - s9(2)(f)(iv) [redacted]
    - Options to reduce valuation costs for businesses if a Valuation Day approach is adopted in extending the taxation of capital gains.

16. We have prepared this report to address these points. We also provide an update on the revised estimate of the revenue from extending the taxation of capital gains.

Tax-free threshold for small business owners

17. Some countries with comprehensive capital gains tax regimes have tax-free thresholds through either (a) lifetime exemptions; or (b) retirement exemptions.

18. We summarise how these thresholds/exemptions generally work and the extent to which they have been adopted by five other countries (Australia, the United Kingdom, the United States, Canada and South Africa) below. We then outline a similar concession that we expect to be proposed by the Group and some factors to consider in whether to adopt such an exemption or concession.

Lifetime and retirement exemptions

19. Under a lifetime exemption, small business owners are not taxed on any capital gains until their gains exceed the level of the threshold for the exemption (accumulated across the taxpayer's life).

20. Under a retirement exemption, small business owners are not taxed on any capital gains realised for retirement. There is generally a minimum age at which the retirement exemption can apply plus other conditions such as the period of time over which the owner must have owned the business.

21. The retirement exemption can be combined with a lifetime exemption such that the gains are not taxed if they are under the threshold.

22. Table 1 summarises our understanding of the lifetime and retirement exemptions in five other countries that have generally been referred to in the Secretariat reports to the Group. Further detail on the exemptions are provided in Appendices [A] to [C] for Australia, Canada and South Africa.

Table 1: Lifetime and retirement exemptions in other countries

Country	Exemption (Yes/No)	Summary
Australia	Yes	Retirement exemption of A$500k (NZ$530k) for gains from small business active assets. If the small business owner is under 55, the exempt gain must be paid into a complying superannuation fund or retirement savings account to qualify. Australia also has a separate retirement exemption for sales of active assets that have been owned by a small business for at least 15 years, provided the owner is at least 55 or is permanently incapacitated.
UK	No	
US	No	
Canada	Yes	Lifetime exemption of C$848k (NZ$950k) for gains from small business corporation shares. C$1m (NZ$1.1m) for gains from farm and fishing property. The exemptions are not cumulative so an individual can never be exempt on more than C$1m of capital gains. Canada applies half-inclusion to capital gains so a C$1m exemption would exempt $500k of taxable gains.
South Africa	Yes	Retirement exemption of R1.8m (NZ$200k) for gains from small business active assets (or shares in small businesses to the extent the business has active assets) for retirement (the small business owner must be at least 55).

Group recommendation

23. We understand the Group is likely to recommend a one-off retirement concession for taxpayers that have owned a closely-held active business for a certain period of time (e.g., 15 years) and sell that business once they reach a certain age (e.g., 60). Rather than exempt the capital gain, we understand the concession is that the first $500,000 of any capital gain from the sale will be taxed at reduced KiwiSaver PIE tax rates (i.e., 5.5%, 12.5% and 28%) that are being proposed by the Group.

24. While this is less concessionary that the Australian retirement exemptions in Table 1, the tax treatment of retirement savings is generally more concessionary in Australia than in New Zealand. Therefore, the Australian retirement exemptions are likely to be less distortionary than they would be in New Zealand, as the exemptions can help ensure that taxpayers who save for their retirement through their small business are not disadvantaged compared to other taxpayers who save for their retirement through tax preferred superannuation funds.[1]

Factors to consider in deciding whether to adopt a lifetime or retirement exemption or concession

25. There are a number of factors to consider in deciding whether to adopt a lifetime or retirement exemption or concession. The primary benefit is that it reduces the tax on small business owners and helps preserve the savings of those who fund their

[1] For example, concessional contributions into a complying superannuation fund are taxed at 15% in the fund; complying superannuation funds' earnings are taxed at 15%; complying superannuation funds' income from assets held to support retirement phase income streams is exempt; and concessional tax rates and tax offsets apply to lump sum and income stream payments from complying superannuation funds.

retirement by selling their small businesses. Lifetime or retirement exemptions, depending on their design, could also remove many small business owners from the taxation of capital gains, reducing their compliance costs.

26. However, this needs to be weighed against a number of other considerations including:

- *Reduced fairness.* Providing a lifetime exemption for saving through a small business but not for other types of savings such as in managed funds, listed shares, rental property or term deposits may be perceived to be unfair. Whether a retirement concession increases or reduces fairness will depend on how consistently it treats small business owners relative to other taxpayers.

- *Reduced efficiency.* Small business tax exemptions may incentivise some undesirable behaviour. For example, some businesses may be dis-incentivised from growing beyond a certain point if larger businesses do not qualify for the exemption, or the business owners may be incentivised to sell a business before it becomes so large that it ceases to qualify for the exemption.

- *Increased complexity and reduced integrity.* Complexity is increased by additional rules required to determine which businesses and assets are eligible for the concession. Moreover, the experience in Australia and Canada is that some high-wealth taxpayers have been able to structure their arrangements to qualify for small business exemptions. All the Australian practitioners we spoke to expressed concern with Australia's small business concessions due to the complexity and integrity issues.

- *Increased compliance costs.* Because of the increased complexity, compliance costs may not be reduced as small business owners may still need to calculate their capital gains and keep track of the use of the lifetime limit over time. If the objective is to reduce compliance costs it is usually better to make the general tax rules as simple as possible, rather than enacting a special concession for small businesses.

- *Reduced revenue.* Exemptions would reduce the revenue collected from the tax. While a small business exemption may seem relatively minor, it may become harder to justify not providing other exemptions or concessions if there is a small business exemption. Both increased compliance costs and reduced revenue can increase the ratio of compliance costs to revenue raised.

27. The relative importance of the factors noted above will depend on the design of the exemption. We can provide further information on lifetime threshold and retirement exemptions if helpful.

28. Overall, we consider that while there may be some benefits in providing an exemption for small business owners, these are likely to be outweighed by other considerations including equity, efficiency and integrity concerns. If the Government wishes to reduce the impact on small businesses of extending the taxation of capital gains, we would suggest considering other measures including compliance cost savings measures proposed by the Group (e.g., lifting the threshold for deductible legal expenditure from $10,000 to $20,000), or other business tax measures such as lifting the threshold for low value asset write-offs (currently $500).

s9(2)(f)(iv)

Note: Pages 7 to 8 have been removed under section 9(2)(f)(iv) OIA

47. s9(2)(f)(iv) [redacted]

48. [redacted]

Valuation costs for businesses

49. You have asked for options to reduce valuation costs for businesses if a Valuation Day approach is adopted in extending the taxation of capital gains. This concern is shared with the Group. Officials' work is ongoing on this matter but we provide a summary of the high level thinking to date below.

50. In brief, we are considering a range of valuation methods taxpayers could use to value their businesses. Some business owners may wish to get their business professionally valued. However, alternative low cost options could be made available, such as:

- *Straight-line valuation* – the value of an asset on Valuation Day is determined by pro-rating the asset's change in value over the time it has been held. This method requires very little information and an online calculator could also be made available to assist taxpayers;[2]
- *Existing reporting standards* – International Financial Reporting Standards (IFRS) require business assets to be valued at a fair market value. If a business uses IFRS, the value on Valuation Day could be the value adopted under those standards; and/or
- *Valuation proxies* – we are exploring whether certain proxies could be used to help determine the value of a business, such as discounted sale price, turnover, type of business, and business assets that can be easily valued.[3]

51. While a professional valuation is likely to be the most accurate method of valuing a business, it may come at a greater cost to the taxpayer. Other methods by contrast may represent a lower cost to the taxpayer but may less accurately represent the associated capital gain or loss incurred.

52. The advantage in allowing taxpayers to select the most suitable method to value their particular business is that it would allow taxpayers to weigh-up trade-offs such as cost, accuracy and simplicity.

[2] South Africa used straight-line valuation as their default valuation method when they introduced their capital gains tax.

[3] South Africa allows business owners to treat 20% of the proceeds of sale to be treated as the value of the asset as Valuation Day and the capital gains tax is then calculated on the remaining 80%.

53. We will report to you on this matter again as the broader workstream of extending the taxation of capital gains develops.

Updated revenue estimate

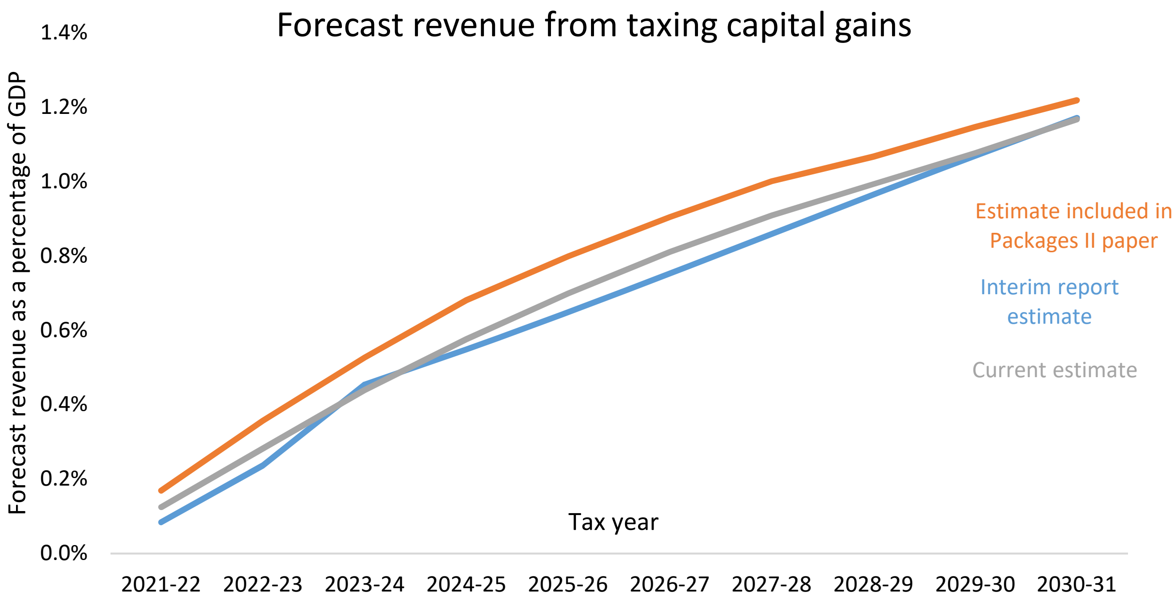
54. Officials have revised down the projected revenue from taxing capital gains more comprehensively. Officials previously provided an estimate that taxing capital gains would raise approximately $10 billion over the first five years following introduction (T2018/3348, IR2018/763 refers). The estimated revenue is now $8.3 billion over the five years. We briefed the Group on these revisions on 19 December 2018.

55. This revised estimate is a result of additional information received by officials and refinement of the modelling approach. In particular the reasons for the changed revenue estimate are:

- Better data:
    - The Secretariat has obtained better data regarding average holding periods for land in New Zealand. The previous holding period data being used by the Secretariat had some low quality data that reduced the average holding period.
    - The Secretariat has updated the behavioural assumptions for the "lock-in effect" (how much longer people will likely hold property for as a result of taxing capital gains). This assumption is now based off the difference in holding periods between Australia and New Zealand.
- Refinement of modelling:
    - Rental loss ring-fencing is now built into the projection so that ring-fenced losses are assumed to be able to be offset against capital gains for residential property on sale.
    - Second homes are now included in the revenue projection

56. The revised estimate will be included in the Tax Working Group's final report. The estimate is still higher than the revenue estimate provided in the Group's interim report ($7.7 billion over the first five years).

57. The better data and modelling refinement have resulted in related changes to the fiscal estimate of some of the revenue-negative measures (e.g., depreciation on buildings) as well. This is set out in the following graph.



Next steps

58. Officials propose to discuss the contents of this report with you on Tuesday 15 January 2019.

59. We will report to Ministers again on 29 January 2019 when we provide the Tax Working Group's final report.

APPENDIX A: AUSTRALIAN EXEMPTIONS

Australia has two capital gains tax ("CGT") lifetime threshold/retirement exemptions for small businesses:[4]

- **Retirement exemption for 15 year assets**. A capital gain from the sale of an active asset that has been continuously owned by a small business for at least 15 years is exempt, provided the business owner is aged 55 or over and is retiring or is permanently incapacitated.
- **Retirement exemption up to AU$500,000 lifetime limit.** Capital gains from the sale of small business active assets are exempt up to a lifetime limit of AU$500,000 (approximately NZ$530,000). If the small business owner is under 55, the exempt amount must be paid into a complying superannuation fund or a retirement savings account to qualify.

The tax treatment of retirement savings is generally more concessionary in Australia than in New Zealand, so Australia's exemptions are less distortionary in that context.

Basic conditions of the concessions

The concessions are only available to "small businesses" that sell "active assets":

- **Small businesses**. The business must have less than AU$2m (approximately NZ$2.1m) of annual turnover and less than AU$6m (approximately NZ$6.3m) of net CGT assets. In applying these thresholds, the turnover and assets of commonly-controlled businesses (40% or more common ownership) and affiliates (another business that the person does not control but is expected to act in accordance with their directions or wishes) are added together.
- ***Active assets.*** A CGT asset will be an active asset if it was owned or used in the course of carrying on a business, or if it is an intangible asset (for example, goodwill) inherently connected with the business. To qualify, an asset must have been an active asset for at least 7.5 years (if owned for more than 15 years), or half the period of ownership (if owned for fewer than 15 years). Shares in another closely-held company can qualify if the other company has 80% active assets. Depreciable property and trading stock do not qualify as they are not CGT assets.

[4] See http://www.ato.gov.au/General/Capital-gains-tax/Small-business-CGT-concessions/.

APPENDIX B: CANADIAN EXEMPTIONS

Canada has two small business lifetime threshold exemptions:

- **Lifetime exemption for small business corporation shares**.[5] A lifetime exemption for gains of up to C$848,252 in 2018 (approximately NZ$950,000) is available to individuals selling shares in a "qualified small business corporation". The exemption is indexed to inflation. At least 90% of the market value of the corporation's assets must be "active assets", which are used mainly in an active business primarily in Canada. Examples of assets that may not qualify include rental property, stocks, and bonds (unless the stocks or bonds are in a connected corporation that is a small business corporation). In addition, during the 24 months before the sale of the small business corporation's shares, the individual (or certain associates) must have owned those shares, and more than 50% of the market value of the corporation's assets must have been used principally in an active business carried on primarily in Canada.

- **Increased lifetime exemption for qualified farm and fishing property.[6]** The lifetime exemption for qualified farm and fishing property is effectively increased to C$1m (approximately NZ$1.1m), with similar conditions as the exemption for small business corporation shares. The exemptions are not cumulative so the "additional exemption" for qualified farm and fishing property in 2018 is C$151,748 (being C$1m less C$848,252). The C$1m amount is not indexed to inflation so, once the indexed exemption for small business corporations exceeds C$1m, that limit will also apply to qualified farm and fishing property (i.e. there will be no additional exemption).

It should be noted that Canada applies half-inclusion to capital gains so a C$1m exemption would exempt C$500,000 of taxable gains.

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[5] Canada Revenue Agency *Capital Gains 2017* (T4037) at https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4037.html.

[6] https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/budget-2015-strong-leadership/lifetime-capital-gains-exemption-qualified-farm-fishing-property.html

APPENDIX C: SOUTH AFRICAN EXEMPTION[7]

South Africa provides a lifetime threshold/retirement exemption of R1.8m (approximately NZ$200k) of capital gains from the sale of small business assets for retirement.

The conditions of the exemption are:

- **Small business**. This is defined as a business that has gross assets with a total market value less than R10m (approximately NZ$1.1m) at the time of sale. Liabilities are ignored in applying the threshold.

- **Active business assets**. These can be either:
  - immovable property (i.e. land) to the extent it is used for business purposes; or
  - other (movable) property used or held wholly and exclusively for business purposes.

  'Passive' assets such as financial instruments (e.g. shares, debt) and assets held in the course of carrying on a business mainly to derive annuity income, rental income, foreign exchange gains, royalties, or similar income are excluded. However, the sale of an entire direct interest in a company of at least 10% may qualify, to the extent that the interest relates to the active business assets of the company. Apportionment is required if the company holds both active and passive assets.

- **5 years of ownership**. The asset must have been held for at least 5 years continuously before the sale.

- **Substantial involvement**. The natural person must have been substantially involved in the operations of the small business during that period.

- **Retirement age.** The individual selling the asset must be at least 55 years old, or else the sale must have been due to ill-health, superannuation or death.

- **Disposals within 24 months**. Capital gains can only qualify for the exemption if they are realised within 24 months of the first qualifying disposal by the individual.

[7] http://www.sars.gov.za/TaxTypes/CGT/Exclusions/Pages/Disposal-of-small-business-assets.aspx

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: **Tax Working Group recommendations: Family home and second homes**

Date:	17 January 2019	**Priority:**	Medium
Security level:	SENSITIVE	**Report number:**	IR2019/014; T2019/035

Action sought

	Action sought	Deadline
Minister of Finance	**Discuss** with officials	N/A
Minister of Revenue	**Discuss** with officials	N/A

Contact for telephone discussion (if required)

Name	Position	Telephone
Samantha Aldridge	Senior Policy Advisor	s9(2)(a)
Steve Mack	Principal Advisor	

17 January 2019

Minister of Finance
Minister of Revenue

Tax Working Group recommendations: Family home and second homes

Executive summary

1. You have asked for advice on:

   - Whether the existing main home exclusion in the bright-line test can be adapted for the purposes of the proposed extension of tax on capital gains, and

   - Whether second homes such as baches should be exempt.

2. This report provides some initial advice on these issues and recommends you discuss this advice with your officials.

Main home definition

3. We consider that the proposed family home exclusion in the context of extending capital gains taxation should be generally based on the existing bright-line main home exclusion. However, we consider that there are some reasons to depart from the definition in the existing bright-line rules. These reasons include:

   - Some aspects of the existing rules could be improved, whether or not there is an extension of the taxation of capital gains. CA ANZ has previously raised potential concerns with the current bright-line rules. We intend to informally consult with CA ANZ to better understand what those issues are.

   - The longer-term nature of taxing more capital gains may require taking a different approach compared to the 5 year bright-line test.

   - Significantly more taxpayers will need to consider whether they fall under the exemption under the proposed new tax rules than was the case under the bright-line rules, which in our view suggests that, in designing the new exemption, simplicity and clarity should be given greater weight.

   - The existing bright-line rules apply only to residential land. If the extension to capital gains includes farmland, additional rules will need to be developed to ensure that the rules cater for owner-occupied farm houses and lifestyle blocks.

4. The TWG is finalising its report to you which includes its proposal for a definition of the excluded home. There are some aspects of their conclusions on the excluded home definition that we are likely to disagree with.

5. We plan to report back in late January and early February on our advice on the TWG recommendations, which will include more detailed advice and options for the proposed main home exclusion rules. We will also advise on whether any of these options are likely to affect the fiscal costs.

Second homes

6. This report also discusses the TWG's proposal to tax second homes, including holiday homes. The TWG proposed taxing second homes in order to enhance fairness and efficiency. Taxing second homes also avoids boundary issues between rental properties which could occur if second homes were exempt but rental properties are taxed (given that many holiday homes are rented out for short periods). It would also be difficult to identify holiday homes separately from second homes.

7. The fiscal cost of exempting second homes would be $430m over the first five years. These fiscal costs are indicative and subject to further quality assurance.

Recommended action

8. We recommend you:

a) note the contents of this report.

Noted   Noted

b) discuss the contents of this report with officials.

Discussion needed/No discussion   Discussion needed/No discussion

Mark Vink
Manager
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Background

9. The Government has committed to excluding the family home from any potential extension of capital gains taxation.

10. Twenty-six submissions were received on the TWG's interim report in relation to the exclusion for the family home. These submissions were largely in favour of having an exemption.

11. An advantage of having a family home exclusion is that, for the majority of taxpayers, it should reduce compliance costs that would otherwise be imposed from taxing more capital gains.

12. Statistics New Zealand estimates suggest that there are 1.88 million dwellings in New Zealand, and of those 1.17 million (62%) are owner-occupied. We expect that the majority of owner-occupied homes are likely to be clearly eligible for the family home exclusion – that is, they should easily be able to be self-assessed as being an excluded home upon disposal. Other properties will clearly not be eligible (e.g. residential rental property owned by an investor).

13. However, a smaller group of home-owners who have more complex situations (e.g. more than one home, a change of use of their home, or where there is mixed use of their home) will need to consider whether the excluded home provision applies to their situation. In designing the rules, judgement calls will need to be made on whether (or to what extent) it is appropriate for the exclusion to apply in these cases.

Family home definition

14. Key issues with the definition of an excluded home that will need to be decided are:

- Who is eligible for the exclusion (i.e. individuals, trusts and other ownership structures)?
- What is a main home?
- If a person has more than one home, which home is eligible?
- What happens when a person uses the home for multiple purposes - i.e. the property is used both for income earning purposes as well as the person's home?
- What happens if there is a change of use - i.e. if the property stops being used as a person's home during the period of ownership?
- How much land surrounding the house is eligible for the exclusion? This is particularly relevant for farms and lifestyle properties.
- Whether there should be a value cap.

15. There are existing concepts of an "excluded home" in two areas of the Income Tax Act:

- the bright-line test and
- the provisions that tax land sales for taxpayers holding land on revenue account (e.g. dealers and developers, and taxpayers who acquire land with the intention of resale).

16. These definitions are broadly similar but differ in detail from each other.

17. Overseas jurisdictions (including Australia) also generally exclude the main home from taxation, and again there are slightly different approaches used in different countries.

18. In our view, the best approach will balance the following factors in an optimal way. The exclusion should:

- be widely viewed as fair and acceptable by most taxpayers;
- have minimal compliance costs for as many home-owners as possible;
- minimise distortions to the extent possible, including distortions affecting how people invest spare capital and how they use their homes;
- minimise the opportunity for abuse; and
- be relatively consistent with overseas models - especially Australia, and any countries that we consider have a best practice capital gains tax.

19. We consider that the proposed family home exclusion in the context of extending capital gains taxation should be generally based on the existing bright-line main home exclusion. We note that the bright-line rules have been in place since 2015. The tax community is now beginning to be familiar with the existing concepts used for the bright-line rules and there has been guidance published by Inland Revenue. As such, we think the existing concepts should be used unless the proposed concepts are clearly better, because this approach is likely to lower compliance costs during the transition period.

20. Some areas where we consider that there are compelling reasons to depart from the definition in the existing bright-line rules are as follows.

21. First, some aspects of the existing rules could be improved. CA ANZ has previously raised potential issues with the current bright-line rules. We intend to informally consult with CA ANZ to better understand what those issues are.

22. Second, there may be a case to depart from aspects of the bright-line rules because the longer-term nature of taxing more capital gains may require taking a different approach compared to the 5 year bright-line test. For example, a home can be exempt under the bright-line test as long as it was the person's main home for the majority of the period of ownership. This might not be an appropriate measure over a longer holding period. If the bright-line test was adopted for the new rules, a person that owned and occupied a property for 10 years and then rented it out for 9 years would be able to claim the exemption for the full period of their ownership. This may not be an appropriate result.

23. Further, significantly more taxpayers will need to consider whether they fall under the exemption under the proposed new tax rules than was the case under the bright-line rules, which in our view suggests that, in designing the new exemption, simplicity and clarity should be given greater weight.

24. Finally, the existing bright-line rules apply only to residential land. If the extension to capital gains includes farmland, additional rules will need to be developed to ensure that the rules cater for owner-occupied farm houses and lifestyle blocks.

25. The TWG is finalising its report to you which includes its proposal for a definition of the excluded home. There are some aspects of their conclusions on the excluded home definition that we are likely to disagree with. We will report back to you in more depth alongside the Group's final report to highlight these areas of difference (along with our views on other TWG recommendations).

Excluding a taxpayer's second home

26. Some submitters to the TWG considered that second homes, including holiday homes, should be exempt. An argument from some of those submitters was that second homes are personal use assets in the same way that owner-occupied housing is, rather than income-producing assets.

27. We consider that there are several reasons for not excluding the second home.

28. One of the reasons for taxing second homes is to improve fairness, so that taxpayers who own wealth in different ways are taxed in a similar way.

29. Another reason for taxing second homes is that they are likely to have time periods where they are not occupied, so there is no efficiency or housing-related reason to exempt them.

30. A further concern is boundary issues between rental properties and second homes. Second homes are often rented out for short periods, so taxing gains from rental properties but not second homes creates boundary issues that could be difficult to address.

31. Finally, we note that second homes are not exempt under the bright-line rule.

Fiscal costs

32. As reported to the Minister of Finance on 11 January, the fiscal cost of exempting second homes is $430 million over the first five years[1]. These fiscal costs are indicative and subject to further quality assurance. Officials had previously estimated $200 million over this period. The reason for revision is that further analysis of Household Economic Survey (HES) data shows that only a subset of second homes were included. Further analysis shows that there is a bigger range of second homes which we have now included.

Next steps

33. We recommend you discuss the contents of this report with officials.

34. We plan to report back in late January and early February on our advice on the TWG recommendations, which will include more detailed advice and options for the proposed main home exclusion rules. We will also advise on whether any of these options are likely to affect the fiscal costs.

35. The development of the family home definition would be subject to the normal generic tax policy process, including a discussion document in the middle of this year. Upon implementation, Inland Revenue would also ensure that that guidance for taxpayers (with examples) would be published.

[1] We have assumed the same turnover rate for second homes as for all residential property. While the turnover rate may be different for different types of residential properties, we do not have sufficient data to assess this.

Inland Revenue
Te Tari Taake
Policy Advice Division

THE TREASURY
Kaitohutohu Kaupapa Rawa

6.

Tax Policy Report: Joint Report: Tax Working Group: Extending the Chair's Appointment

Date:	24 January 2019	**Report No:**	T2019/120 IR2019/032
		File Number:	SH-13-7-8-6

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Sign** the attached letter for Sir Michael **Refer** the attached letter to the Minister of Revenue for his signature	29 January 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
s9(2)(a)	Project Coordinator, Tax Working Group	s9(2)(a)	N/A (mob)	✓
Jordan Ward	Team Leader, Tax Working Group		N/A (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Refer the report and attachment to Hon Stuart Nash, Minister of Revenue.

Return the letter, signed by both Hon Robertson and Hon Nash, to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes (attached)

Tax Policy Report: Joint Report: Tax Working Group: Extending the Chair's Appointment

Executive Summary

This report attaches a letter to extend the appointment of the Chair of the Tax Working Group to 30 June 2019.

The members of the Tax Working Group (the Group) were appointed until the delivery of the Final Report (the report) to the Government. This is currently expected to occur in late January 2019.

We understand the report will be published and presented to the public by the Group rather than the Government. In order to facilitate this, the Group will need to be able to respond to the media and issue corrections. Treasury and Inland Revenue (the Secretariat) recommend that the appointment of the Chair of the Group (Sir Michael Cullen) be extended to allow him to carry out these duties.

You can extend the Chair's appointment until the report is delivered to Government.

Recommended Action

We recommend that you:

a **agree** to extend Sir Michael Cullen's appointment as Chair of the Tax Working Group

Agree/disagree

b **sign** the attached letter for Sir Michael

Signed/not signed

c **refer** the attached letter to the Minister of Revenue for his signature

Refer/Not referred

d **notify** Officials if you want to take an Oral Item to the Appointments and Honours Cabinet Committee to inform them of your decision to extend Sir Michael's appointment

Notified/not notified

e **note** the Secretariat will continue to support Sir Michael, and no additional funding is sought

f **note** that if you agree to this extension, the Secretariat intends to extend the Independent Advisor's contract

Jordan Ward
Team Leader, Tax Working Group
The Treasury

Emma Grieg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance

Tax Policy Report: Joint Report: Tax Working Group: Extending the Chair's Appointment

Purpose of Report

1. The Tax Working Group (the Group) delivers its Final Report (the report) to the Government in late January 2019. The appointment letters to the Chair and members of the Group state:

   Your appointment takes effect from the date of your acceptance of this appointment letter, and continues to the date the Group provides its final report to Ministers, which is scheduled to be in February 2019.

   The report is being delivered early, so this appointment end date has shifted as well.

2. Once the report is delivered, there are activities that would benefit from the continued involvement of the Chair. These include:

   a Facilitating the delivery of the report to the public,

   b Speaking to media about the report, including radio and television interviews,

   c Ensuring the reporting on the recommendations is correct, including issuing corrections, and

   d Attending appropriate speaking opportunities to discuss the report's recommendations.

3. There are 11 members of the Group, including the Chair. The Secretariat recommends the Chair's appointment be extended, as the spokesperson for the Group. Having the Chair complete the activities outlined above promotes clarity on what the *Group* has recommended, in relation to the *Government's* decisions.

Length of Extension and Supporting the Chair

4. The Secretariat anticipates that there will be ongoing media requests and clarifications required until the Government has announced its decisions. The announcement is expected in the first half of 2019. We recommend Sir Michael's appointment be extended until 30 June 2019, the end of the Tax Working Group's appropriation.

5. The Secretariat will continue to support the Chair; this will be managed within current staffing levels, and is not anticipated to have an impact on capacity.

Communication and Consultation

6. As the Group's appointment letters are public, an announcement of the extension will be required. The Secretariat recommend you address this through a Press Release, either as part of acknowledging the report's handover to Government, or as part of the response on the day of release.

7. Treasury has confirmed an extension would not need to be considered by the Appointments and Honours Cabinet Committee. If you want to notify those colleagues

about the extension, we recommend taking an Oral Item to the next meeting on Wednesday 13 February 2019.

8. If you agree to extend the appointment of the Chair, the Secretariat intends to extend the contract of the Independent Advisor, Andrea Black. The Treasury is able to extend the Independent Advisor's contract without further input.

Terms of the Extension

9. We do not propose any change to the terms of the appointment (remuneration, costs, conflicts of interest and confidentiality). For further detail on these, please see the attached original appointment letter.

Costs Involved

10. Sir Michael's rate for this appointment is $1,062.00 per day over 6 hours. Travel and accommodation costs are also included. No additional funding is being sought to cover these costs; we anticipate they will be met through the current appropriation.

Sir Michael Cullen
s9(2)(a)
[redacted]

Dear Sir Michael

Extension of Appointment as Chair of the Tax Working Group

We have the pleasure of extending your appointment as Chair of the Tax Working Group (the Group).

Your current appointment ends when the Tax Working Group Final Report is delivered to the Government – currently expected on 29 January 2019. This means the publication of the report, and subsequent media discussions and corrections, fall outside of your appointment.

Term of Appointment

This extension takes effect immediately following the delivery of the Final Report to the Government, and ends on 30 June 2019.

The Ministers of Finance and Revenue may remove you from the position as Chair of the Group for any reason by giving notice in writing, which may take effect immediately. Similarly, you may resign form your position as Chair of the Group at any time by giving the Ministers of Finance and Revenue notice in writing.

Duties and Responsibilities

This extension is to enable you to facilitate the presentation of the Tax Working Group Final Report to the public, and to ensure the Group's recommendations are reported accurately. Further consideration of the tax system is not intended to take place during the extension period.

Other Terms

Your extended appointment will be subject to the same terms of remuneration, costs, conflicts of interest and confidentiality as set out in your original appointment letter.

Please indicate your acceptance of your extension by signing and dating below, and return it to Mark Vink, Tax Strategy Team, The Treasury, 1 The Terrace Wellington 6011.

Yours sincerely

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Acceptance of extension
I, Sir Michael Cullen, hereby accept the extension of my appointment as Chair of the Tax Working Group in accordance with the Terms of Reference and the terms contained in this letter.

____

Signature

____

Date

Hon Grant Robertson

MP for Wellington Central

Minister of Finance

Associate Minister for Arts, Culture and Heritage

Minister for Sport and Recreation

Sir Michael Cullen
s9(2)(a) [redacted]

Dear Sir Michael

Appointment as Chair of the Tax Working Group

We have pleasure in formally appointing you as Chair of the Tax Working Group.

Background

As set out in the attached terms of reference, the purpose of the Group is to examine further improvements in the structure, fairness and balance of the tax system.

Your role

You are being appointed as Chair of the Group to consider changes in the tax system and to make recommendations in a final report to Ministers.

As Chair of the Group, you will be responsible to the Ministers of Finance and Revenue for all actions taken, reports issued or advice given by the Group. You will also be responsible for all administrative matters including determining the time and location of meetings, setting the agenda, gathering the necessary papers and inviting attendees, with assistance from the Group's secretariat

Our expectations for yourself and the Group, which have been included in the members' letters of appointment, are that:

- members will need to attend meetings (via teleconference if physical attendance is not possible) of the Group every two to three weeks, to be held in Wellington
- members may also need to attend some of the Group's external engagement events
- members will have thoroughly prepared for these meetings and events, and will participate fully, frankly and constructively.

+64 4 817 8703 Private Bag 18041, Parliament Buildings, Wellington 6160, New Zealand g.robertson@ministers.govt.nz beehive.govt.nz

Term of appointment

Your appointment takes effect from the date of your acceptance of this appointment letter and continues to the date the Group provides its final report to Ministers, which is scheduled to be in February 2019.

This appointment may be extended by written agreement while the appointment remains in force.

The Ministers of Finance and Revenue may remove you from the position as Chair of the Group for any reason, or may terminate the Group's operation, by giving notice in writing, which may take effect immediately. Similarly, you may resign from your position as Chair of the Group at any time by giving the Ministers of Finance and Revenue notice in writing.

Acting Chair

As Chair, you may designate in writing any other member of the Tax Working Group to act in your place. Any person so designated will assume all responsibilities of the Chair for the period of time they are so designated.

Remuneration

As Chair of the Group, you will be paid the daily remuneration fee for a Group 4, Level 1 body under the Cabinet Fees Framework (CO (12) 6). This equates to a rate of $1,062 per day and includes payment not only for attendance at meetings, but also work properly undertaken outside of meetings (for example preparation for meetings, report writing, and review of the same). However, if work on a day as Chair of the Group involves less than 6 hours of time, the aforementioned daily rate is to be divided by 8 and then multiplied by the number of hours actually worked. Fee invoices presented must include details of the actual number of hours worked

Costs

The Treasury will be meeting expenses related to the direct costs of setting up, running and supporting the Group. Costs incurred as a result of activity associated with the Group will be managed by the Treasury in conjunction with yourself. Any expenses you incur on behalf of the Group will need to be agreed in advance with the Treasury and will be reimbursed on receipt of appropriate documentation.

In particular you and the Group will also be reimbursed actual and reasonable expenses incurred, including:

- transport expenses (taxis, busses, trains, and return flights for those members of the Group who ordinarily reside outside Wellington) that comply with the Treasury's travel policy;
- accommodation of the type approved by the Treasury for those members who ordinarily reside outside Wellington;
- breakfast and evening meals for members of the Group who ordinarily reside outside Wellington;

that in each case have been approved in advance by the Treasury in writing.

Any expenses claims presented or charged to the Treasury in respect of expenses incurred by or for a Group member that have not been approved in advance by the Treasury in writing, may be paid by the Treasury by off-set against fees payable to the member.

Note that in the event of a dispute in relation to a fees invoice or an expense claim, the Treasury reserves the right to withhold payment for the whole or any part of that fees invoice or expense claim that is notified by the Treasury as being in dispute until such dispute is resolved to the reasonable satisfaction of the Treasury.

Conflicts of Interest

As Chair, you will keep a register of any conflicts of interest that have been identified by you or members of the Tax Working Group. It is expected that the Chair and members will declare conflicts of interest where they arise, preferably before meetings, and may need to excuse themselves from discussions if the conflict is of a significant concern.

It is also possible that you may be placed in a situation where, as a result of circumstances which are not related to your position as Chair of the Group, your continuing to act as Chair might nevertheless place the Group or Ministers in a position of embarrassment. If you find yourself in such a situation you must take the initiative and raise the matter with the Ministers of Finance and Revenue. While there are no set criteria for such situations, examples include:

- where legal proceedings have been, or are likely to be, brought against you;
- where you have been, or are likely to be, subject to negative media or public scrutiny;
- where you are placed in a situation of actual or perceived conflict of interest;
- any issue affecting your ability to contribute to the Group (for example, as a result of other time pressures, extended overseas travel (i.e. more than two months), illness, etc); and
- any other similar circumstance which may place the Group or Ministers in a position of embarrassment.

Confidentiality

You confirm that you will not use or disclose any confidential information obtained through your role (other than to the extent necessary for your role) unless the Ministers of Finance and Revenue give prior written approval for the use or disclosure, or the use or disclosure is required by law or parliamentary convention.

If you require any assistance, please contact the Manager of the Tax Strategy Team in the Treasury, Mark Vink: mark.vink@treasury.govt.nz; DDI: 04 917 6952.

Please indicate your acceptance of your appointment by signing and dating the below, and return it to Mark Vink, Tax Strategy Team, The Treasury, 1 The Terrace Wellington 6011.

Yours sincerely

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Acceptance of appointment

I, Sir Michael Cullen, hereby accept the appointment as Chair of the Tax Working Group in accordance with the enclosed Terms of Reference and the terms contained in this letter.

____

Signature

____

Date

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

POLICY AND STRATEGY

Joint Report: Fiscal and distributional analysis s9(2)(f)(iv) KiwiSaver proposals

Date:	28 January 2019	**Report No:**	T2019/1 IR2019/013
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the analysis included in this report **Agree** to discuss analysis with officials at Joint Ministers meeting on 29 January 2019	29 January 2019
Minister of Revenue (Hon Stuart Nash)	**Note** the analysis included in this report **Agree** to discuss analysis with officials at Joint Ministers meeting on 29 January 2019	29 January 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
s9(2)(a)	Analyst, The Treasury	s9(2)(a)	✓
Matt Nolan	Senior Analyst, Inland Revenue		
Matt Benge	Chief Economist, Inland Revenue		
Matt Cowan	Team Leader, The Treasury		

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Joint Report: Fiscal and distributional analysis s9(2)(f)(iv) [redacted] KiwiSaver proposals

Executive Summary

At your meeting with officials on 17 December 2018, you requested information on the following:

- s9(2)(f)(iv) [redacted]
- Distributional analysis of the Tax Working Group's KiwiSaver proposals.

s9(2)(f)(iv) [redacted]

KiwiSaver proposals

The Tax Working Group has proposed several changes to KiwiSaver. The analysis in this report shows the gains made from these proposals by KiwiSavers in different income groups. It compares these to the cost of the additional tax on KiwiSaver funds from taxing more capital gains.

s9(2)(f)(iv) [redacted]

Recommended Action

We recommend that you:

a **Note** the analysis in this report.

Noted *Noted*

b **Agree** to discuss the analysis with officials on 29 January 2019.

Agreed / not agreed *Agreed / not agreed*

Matt Cowan
Team Leader
The Treasury

Matt Benge
Chief Economist
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

s9(2)(f)(iv)

Joint Report: Fiscal and distributional analysis s9(2)(f)(iv) [redacted] [redacted] KiwiSaver proposals

1. Purpose of Report

1. This report responds to your requests for:

- s9(2)(f)(iv) [redacted]
- Distributional analysis of the Tax Working Group's KiwiSaver proposals.

s9(2)(f)(iv) [redacted]

Note: Pages 6 to 10 have been removed under section 9(2)(f)(iv) OIA

s9(2)(f)(iv)

[redacted]

4. KiwiSaver proposals

34. The Tax Working Group has proposed several changes to KiwiSaver (T2018/3429, IR2018/800 refers). Table 6 below shows the distributional impact of these proposals. For different income groups, it shows the aggregate cost to KiwiSavers as a result of taxing more capital gains from KiwiSaver funds, and compares this to the aggregate gain as a result of each KiwiSaver proposal.

Table 6: Impact of KiwiSaver proposals, (2021/22)

	Aggregate cost / gain		
	$0-48,000	**$48,000-$70,000**	**$70,000+**
Additional tax on KiwiSaver funds from taxing more capital gains	*-$19m*	*-$19m*	*-$46m*
ESCT exemption for those earning less than $48,000	$180m	$0m	$0
ESCT exemption, with 6c abatement for every dollar earnt above $48,000	$180m	$96m	$0
Increase member tax credit from $0.50 for every $1 of contribution to $0.75	$227m	$130m	$133m
Member tax credit for primary caregiver	$7m	$2m	$3m
Reduce lower PIE rates for KiwiSaver by five percentage points	$70m	$24m	$0m

Source: Tax Working Group

35. Officials consider that these measures are unlikely to significantly increase the amounts that individuals contribute to their KiwiSaver funds. If the Government's objective is to support the overall lifetime welfare of lower income households more generally, we consider that changes to the tax and welfare settings are likely to be more effective than these KiwiSaver measures.

Note: Pages 12 to 14 have been removed under section 9(2)(f)(iv) OIA

s9(2)(f)(iv) [redacted]

Inland Revenue
Te Tari Taake
Policy Advice Division

8.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Joint Report: Tax Working Group Final Report

Date:	1 February 2019	**Report No:**	T2019/174 IR2019/040
		File Number:	SH-13-7-8-4

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the attached Final Report of the Tax Working Group **Note** the attached letter from the Chair of the Tax Working Group	N/A
Minister of Revenue (Hon Stuart Nash)	**Note** the attached Final Report of the Tax Working Group **Note** the attached letter from the Chair of the Tax Working Group	N/A

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
s9(2)(a)	Project Coordinator	s9(2)(a)	N/A (mob)	✓
Jordan Ward	Team Leader, Tax Working Group		s9(2)(a)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Tax Policy Report: Joint Report: Tax Working Group Final Report

Executive Summary

This report delivers, on behalf of the Tax Working Group, the Group's Final Report. A covering letter from the Chair is also attached.

The Final Report consists of two volumes:

a. Volume I: *Recommendations, and*
b. Volume II: *Design Details of the Proposed Extension of Capital Gains Taxation.*

We understand the Group intends to publish the covering letter with the Final Report.

For your reference, a copy of the Tax Working Group's Interim Report is also attached, which is referred to in the Final Report.

Recommended Action

We recommend that you:

a **note** the attached Final Report (volumes I & II) of the Tax Working Group, and
b **note** the attached letter from the Chair of the Tax Working Group.

Jordan Ward
Team Leader, Tax Working Group
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Joint Report: TWG Final Report - Draft Cabinet paper and draft briefing materials

Date:	1 February 2019	**Report No:**	T2019/155 IR2019/048
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Provide feedback** on the enclosed documents	5 February 2019
Minister of Revenue (Hon Stuart Nash)	**Provide feedback** on the enclosed documents	5 February 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
s9(2)(a)	Analyst, The Treasury	s9(2)(a)	n/a	✓
Jordan Ward	Team Leader, The Treasury		n/a	
Emma Grigg	Policy Director, Inland Revenue		n/a	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Tax Policy Report: Joint Report: TWG Final Report - Draft Cabinet paper and draft briefing materials

1. The Tax Working Group (TWG) has provided you with its Final Report.

2. We understand that you would like to brief your colleagues on the Final Report, and take the Final Report to Cabinet before it is released.

3. We have prepared a draft Cabinet paper for your consideration (enclosed). The paper is structured in three parts:

   a A summary of the key findings of the Final Report;

   b An explanation of how potential tax changes could support the Government's economic strategy. We have linked this to the economic narrative draft Cabinet paper [T2018/2108, MBIE 0709 18-19 refers];

   c The next steps for how the Government plans to respond to the final report, including key messages for Ministers.

4. We have also prepared three draft products to support communication materials and briefing your colleagues. The focus of these three documents is the TWG's recommendations on capital income taxation, although they also summarise some of the TWG's other findings. The documents are:

   a an 8-page 'covering note' to inform possible communication materials;

   b an A3 for briefing colleagues;

   c a short slide pack which could also be used for briefing colleagues.

5. We welcome your feedback on these documents and will continue to work with your Offices on further edits over the coming week.

Recommended Action

We recommend that you:

a **provide feedback** on the enclosed documents

Jordan Ward
Team Leader
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Tax Working Group Final Report

Summary note ('Covering note')

The Government's priorities and links to the tax system

1. This Government has the goal of building an inclusive, sustainable and productive economy, improving the wellbeing of New Zealanders and their families.
2. The tax system plays a critical role in supporting the wellbeing of New Zealanders. As highlighted in the Tax Working Group's Final Report:
   a. Taxes create a fairer, more inclusive society by redistributing income, reducing inequality and allowing New Zealanders to fully participate in society regardless of their market income.
   b. Taxes fund essential public goods and services that underpin our living standards.
3. Achieving this requires thoughtful, balanced tax policy. This Government's objectives for the tax system are:
   a. a progressive tax and transfer system for individuals and families;
   b. a system that treats all income and assets in a fair, balanced and efficient manner;
   c. a system that promotes the long-term sustainability and productivity of the economy;
   d. a system that supports a sustainable revenue base to fund government operating expenditure around its historical level of 30 per cent of GDP; and
   e. a tax system that is efficient, fair, simple and coherent, collecting the tax that is due on time and in full.

An assessment of the tax system

4. New Zealand's tax system has many strengths. It allows the Government to raise significant amounts of revenue at rates lower than in most other OECD countries.
5. However, as the Group's Final Report highlights, our tax system has weaknesses.
   a. It is not fair for all New Zealanders. It does not treat all income equally. Some forms of income go untaxed, most notably many types of capital income. This means that there is less revenue available to improve the wellbeing of New Zealanders and their families.
   b. It is not particularly progressive. Wealthier individuals receive more of their income through untaxed capital income that poorer individuals. Wealthier individuals are also able to use complex tax planning to reduce the tax they paid. Tax and transfer systems in other countries combat inequality more effectively than we do. Further, the inequality-reducing power of our tax and transfer system has fallen in recent decades.
   c. The system also relies on a relatively narrow range of taxes. For example, as well as not taxing many types of capital income, New Zealand uses environmental taxes less than most OECD countries.

Measures already taken

6. The Government has started to improve the tax and transfer system.

Supporting low- and middle-income families

7. *Families package*: In our first 100 days, this Government passed the Families Package, supporting especially low- and middle- income families with children. Key measures included:
    a. boosting the incomes of low- and middle-income families with children by increasing the Family Tax Credit and raising the abatement threshold. An estimated 26,000 families are eligible for Working for Families as a result of the changes;
    b. introducing the Best Start payment to help families with costs in a child's early years;
    c. increasing the Accommodation Supplement and Benefit;
    d. introducing the Winter Energy Payment to help older New Zealanders and New Zealanders receiving a benefit with costs over winter, which around 1 million people can receive if necessary;
    e. increasing the period for paid parental leave to 26 weeks;
    f. reinstating the Independent Earner Tax Credit, cancelled by the previous Government, which provides up to $520 per year to some individuals earning between $24,000 and $48,000; and
    g. rolling back the previous Government's planned tax cuts, which would have provided a larger tax cut for the top income earners than those earning less than $52,000.

8. The fiscal implications of the Families Package are shown below:[1]

	$m - increase/(decrease)					
	2018/19	**2019/20**	**2020/21**	**2021/22**	**2022/23 & outyears**	**5-YR total**
Total expenditure impact	(1,157.000)	(1,309.000)	(1,525.000)	(1,616.000)	(1,616.000)	**(7,223.000)**
Total revenue impact - *Tax Revenue*	1,904.000	1,904.000	1,993.000	2,077.000	2,077.000	**9,955.0000**
Total fiscal impact	**747.000**	**595.000**	**468.000**	**461.000**	**461.000**	**2,732.000**

[1] The Families Package included the repeal of tax cuts, which had a total positive revenue impact of $8.364 billion over the forecast period beginning 2017/18.

9. *Secondary tax changes*: The Government is in the process of addressing concerns with secondary tax codes, which will ultimately mean they are no longer necessary. We are changing the law to make it easier for taxpayers with multiple jobs to pay the right amount of tax from the start, rather than receiving a tax refund or debt at the end of the tax year. These changes will apply from 1 April 2019. There are no material fiscal implications arising from these changes

Levelling the playing field

10. *GST on low-value imports*: The Government has introduced legislation that will require businesses selling low-value goods into New Zealand to collect GST. The changes put local retailers on a level playing field with foreign firms who have taken advantage of this tax break.

11. *Extending the bright-line:* The Government has extended the bright-line test to five years in order to better ensure that speculators pay tax on the capital gains they make on their property investments.

12. *Loss ring-fencing:* Legislation has been introduced to ring-fence residential rental losses. Currently, property investors can subsidise part of the cost of their mortgages through reducing their tax on other income, helping them outbid owner-occupiers.

Ensuring multinationals pay their fair share

13. *Base erosion and profit-shifting (BEPS):* The Government has introduced and enacted legislation to restrict the ability for multinationals to use base erosion and profit shifting (BEPS) tactics to reduce the tax they pay both in New Zealand and overseas.

14. The expected revenue of these measures are as below:[2]

	$m - increase/(decrease)					
Vote Revenue	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23 & outyears**	**5YR Total**
GST on Low Value Goods *- Tax Revenue:*	-	66.000	100.000	112.000	126.000	**404.000**
Residential loss ring-fencing. *- Tax Revenue:*	-	35.000	190.000	190.000	190.000	**605.000**
Extending the bright-line *- Tax Revenue:*	-	-	10.000	30.000	50.000	**90.000**
Base Erosion Profit Shifting *- Tax Revenue:*	112.500	206.000	206.000	201.000	187.000	**912.500**

[2] Figures are as at HYEFU 2018.Figures are shows as fiscal years ending 30 June.

15. *Taxing the digital economy:* The Government is prepared to take further action to ensure multi-national companies pay their fair share. We are working with other countries at the OECD on a multilateral solution, but we need to be ready to act earlier if that process does not speed up. The Government has directed officials to conduct a public consultation process to consider options for taxing the digital economy. While the challenges created by the digital economy require significant discussion both internationally and within New Zealand, the Government cannot sit and wait for these companies to pay their fair share of tax voluntarily, or wait for multilateral processes to play out.

The Tax Working Group

16. The Government established the independent Tax Woking Group in November 2017 to examine improvements to the structure, fairness, and balance of the tax system.

17. The Group delivered its *Interim Report* in September 2018, and its *Final Report* on 1 February 2019.

18. The Group's reports deal with a number of complex tax issues in significant detail and makes a large number of recommendations.

Challenges to the structure, fairness and balance of the tax system

19. The Group finds that one of the key issues impacting the structure, fairness and balance of the tax system is the inconsistent treatment of capital income.

20. A fair tax system should have two main features:
    i. A tax base that taxes a wide range of income, so that the tax paid is spread fairly – put simply, people earning the same amount of income should pay the same amount of income tax regardless of its source (see example below).
    ii. People with more capacity to pay (i.e. richer people) should pay a greater share of their income in tax. This is what makes a tax system progressive.

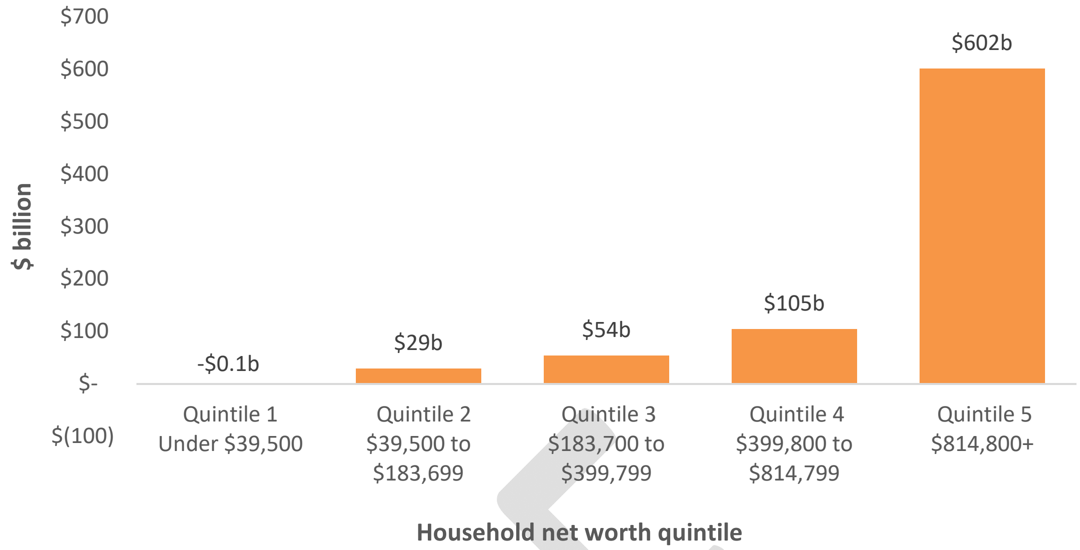
21. The current treatment of many types of capital income fails the first test of fairness. This is illustrated in the example below.

22. The Group also finds that the current treatment of capital income undermines the second test – the progressivity of the tax system.

23. Overseas studies show that high-income earners derive a much greater share of their income from capital gains than low- and middle-income earners. When capital gains are not taxed, those on higher-incomes benefit the most.

24. We also have evidence of this unfairness In New Zealand. Figure 1 below shows the distribution of wealth. A vast majority of wealth owned by New Zealanders is held by the wealthiest 20% of households. This suggests that a vast majority of untaxed capital income is also going to wealthy households.

Figure 1: Total net worth (excluding owner-occupied housing) by net worth quintile (2015)[3]



Source: Stats NZ (HES 2015)

25. Extending capital income taxation will also improve the integrity of the tax system. It will prevent some high-income individuals from using complex tax planning to reduce the tax they pay.

26. Extending capital income taxation over a broad range of assets will also help level the playing field between different types of investments.

The Tax Working Group's recommendations

Capital income taxation

27. All of the Group support extending capital income taxation to at least residential rental investment properties In addition, a clear majority of the Group support a broader extension that applies to most asset types (but not the family home).

28. A minority of Group did not support a broad extension of capital income taxation, in part due to concerns about compliance and administration costs. They only supported extending capital income taxation to cover residential rental investment properties.

29. The TWG has made it clear that a spectrum of choices is available when considering an extension of capital income taxation. These choices include which types of assets should be subject to the tax, and how best to stage the timing of introduction.

High level design

30. A clear majority of the Group supported a broad system for taxing capital income. This would involve:

    a. taxing increases in value on a broad range of assets including residential, commercial and industrial property (but not the family home), shares, and business assets;

[3] Note: Net worth estimates exclude owner-occupied housing. Quintiles are based on household net worth, including owner-occupied housing

b. only collecting tax when an asset is sold or transferred (with some exceptions e.g. managed funds);

c. deferring tax in some circumstances (e.g. inheritance, relationship property transferred, sole trader putting business into a company);

d. treating capital income the same as other income, which means taxing it at appropriate income tax rates (e.g. 28% for companies and marginal rates for individuals) and with no adjustment for inflation; and

e. only taxing gains that occur after the tax is implemented (e.g. 1 April 2021).

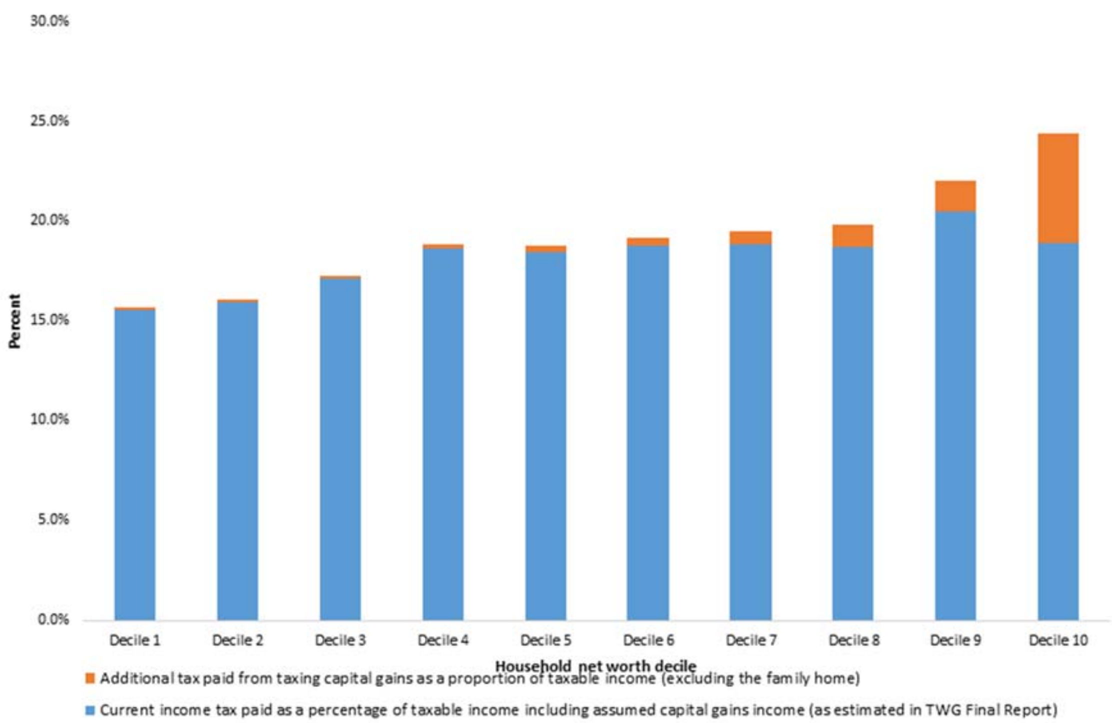
31. Most of these high-level design principles are similar to how other jurisdictions tax increases in the value of capital assets. Areas where the TWG's recommendations differ from the international norm are:

    a. **The tax rate** – the proposal would result in capital gains earned in companies and distributed to individuals beings taxed at the low end of effective tax rates internationally. This is because of our imputation system which relieves double taxation of income earned through companies. The proposal would also tax capital gains earned by individuals directly relatively highly.

    b. **Capital loss ring-fencing** – the TWG is recommending a relatively generous treatment of losses compared to many other countries. This would limit the impact that the tax would have on risk-taking.

32. Indicative analysis has found that the impact of the tax would generally fall on the wealthiest households (see Figure 2 below). Extending capital income taxation would have a minor impact on the average effective tax rate paid by most households, with the most significant impact occurring for wealthiest 10% of households.

Figure 2: Average effective income tax rates by household net worth decile [4]



Source: Stats NZ (HES 2015); the Treasury

Disadvantages

33. The Group has acknowledged that extending capital income taxation will lead to compliance costs for asset owners, particularly when the tax comes into effect. However, they have identified a number of options which could minimise these costs.

    a. Some assets with clear market values (e.g. listed shares) will not need to be valued.

    b. There will be a set of default valuation rules for asset owners that do not want a valuation.

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[4] Capital gains: The estimates for capital gain used in this analysis are from the Tax Working Group Final Report. The share of capital gains tax liability by household net worth decile is based on the share of assets (excluding cash, deposits and owner occupied housing) by household net worth decile. Capital gains tax revenue estimates have been discounted to tax year 2021/22 (assuming 3 percent annual capital gain, and taxed at an average marginal tax rate of 26 %). Revenue from taxing more capital gains will be low in the first 4 years after implementation. For this reason, revenue from taxing more capital gain is discounted from year 5, or tax year 2025/26. The imputed capital gains excludes gains that would be subject to rollover relief.

Data: Although the taxation of capital gains is envisaged to take effect after tax year 2021/22, the corresponding data on personal income tax by household net worth decile is not available for this period. The data for household economic survey used is 2014/15. While Stats NZ released Household Economic Survey 2018 (for tax year 2017/18) in December 2018, the underlying data is not yet available for the purpose of this analysis. Specific data relating to capital gains in New Zealand is highly limited. The estimate is subject to significant uncertainty and should be considered as indicative only.

c. Asset owners that do want a valuation would have up to 5 years to determine the value of their asset.

34. The Group also acknowledged that extending capital income taxation could also have some negative impacts on saving and investment. However, the Group identified a number of complementary measures that could help offset this effect. These measures were considered as parts of a series of complementary packages of measures that could be considered alongside an extension of capital income taxation.

A complementary package of measures

35. The Group estimates that extending capital income taxation over a broad range of assets would generate approximately $8.3 billion over the first five years of the tax (2021/22 – 2025/26).

36. Any revenue generated from extending capital income taxation will be recycled to increase the income of New Zealanders, and to support businesses through the changes to the tax system.

37. The Group has proposed a range of measures designed to achieve this goal. The Government will carefully consider what measures would be appropriate to complement the gains in fairness achieved and to promote a productive and efficient economy.

Business/housing measures

38. The Group has identified a wide range of opportunities to reduce compliance costs (especially for small businesses), remove investment distortions for New Zealand businesses, and promote a more efficient housing market. Some of the key measures are:

    a. **allowing businesses to claim depreciation expenses on buildings** – encourage more business investment (range of options);
    b. **allowing business to deduct expenses for "black hole" expenditure** – encourage innovation and entrepreneurship;
    c. **allowing businesses to keep losses when the owner changes** – make it easier for small companies to expand; and
    d. **removing residential loss ring-fencing** – recognising that gains would be taxed and could reduce upward pressure on rents.

Savings measures

39. Extending capital income taxation would also result in higher taxes for people who are saving for their retirement, including people who are using KiwiSaver.

40. The Group has identified some measures that would help compensate for these higher taxes. These measures are:

    a. **a KiwiSaver tax exemption** – remove tax on employer KiwiSaver contributions to lower income KiwiSavers;

    b. **increase the KiwiSaver member tax credit –** increase Government contributions to all KiwiSavers; and

    c. **reduce KiwiSaver PIE rates** – give lower income KiwiSavers the same benefit as those in the highest tax bracket.

41. These measures could offset the impact of extending capital income taxation on KiwiSaver earnings.

The digital economy

42. The Group has explored opportunities to ensure that the tax system deals appropriately with the digital economy. The Group recommends that the Government stand ready to implement a tax on digital services if a critical mass of other countries moves in that direction, and if it is reasonably certain that New Zealand's export industries will not be materially impacted by any retaliatory measures.

43. In response to this recommendation, the Government has directed officials to conduct a public consultation process for options on taxing the digital economy. While the challenges created by the digital economy require significant discussion both internationally and within New Zealand, the Government cannot sit and wait for these companies to agree to pay their fair share of tax, or wait for the multilateral processes to play out.

Environmental taxation

44. The Group has noted that New Zealand makes relatively little use of environmental taxes, and believes that taxation could be used further to enhance environmental outcomes. The Group has developed a policy framework for assessing when environmental taxes could be usefully applied.

45. The Government welcomes the development of this framework as a tool for delivering positive environmental and ecological outcomes for New Zealand.

46. The Government also welcomes the Group's efforts to highlight specific areas where there is greater scope to use environmental taxes (subject to further design work). The Government has ongoing work programmes on all of the issues highlighted as immediate priorities by the Group.

Personal income taxation

47. The Group has considered a range of options to increase the progressivity of the personal tax system, including the possibility of a tax-free threshold. The Group's preferred option is to increase the bottom threshold of income tax, with a potential increase in the second marginal tax rate.

48. The Group notes, however, that choices around personal income taxation should depend on the objectives of the Government. For example, if the Government wishes to improve the

incomes of the very poorest members of society, then changes to benefit rates are likely to be a more effective policy tool than changes to tax rates.

49. The Group also suggests that the Government consider increasing net benefits to match any personal tax changes. This would provide a fairer redistribution of revenue across individuals, and have a greater impact on poverty reduction.

Future challenges

50. The Group has also identified a need to future-proof the tax system. Changes in society and technology may undermine the current structure of the tax system.

51. In the future, for example, it is likely that more people will work for themselves and operate in the 'gig economy.' This may reduce the effectiveness of the PAYE system of withholding tax, which has previously been a reliable means to collect tax from individuals' employers.

Next steps

52. The Final Report provides a range of choices and options for the Government's consideration. The Government will need to work through all of these choices and options before arriving at policy decisions. Consultation between coalition and confidence and supply parties will be an important part of this process.

53. In a number of areas, the Government is already taking steps in the direction suggested by the Group, such as the areas of taxing the digital economy and using environmental taxes to promote a sustainable economy.

54. There will be further opportunities for the public to have its say as any legislative process will include a period of public consultation on these issues.

April 2019* *subject to consultation between coalition and confidence and supply parties	Cabinet decisions on Group's recommendations
April to August 2019	Consultation on government proposals (if any)
October - December 2019* *additional time to incorporate legislative package	Bill introduced
July 2020	Legislation passed and enacted
April 2021	Implementation

SENSITIVE

Tax Working Group – Summary of Final Report

The Tax Working Group was asked to examine improvements in the structure, fairness and balance of the tax system.

Taxing capital income (capital gains)

What the Group is proposing

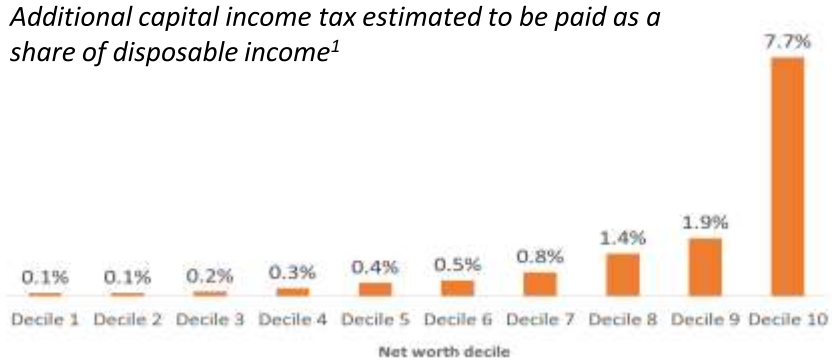
- All members of the Group recommend extending capital income taxation, although there is disagreement about how far this should go.
- **Majority**: Recommends gains should be taxed for most assets. Projected to raise $8.3 billion in first five years (2021/22 - 2025/26).
- **Minority**: Recommends only taxing gains from selling residential rental properties.
- There is a spectrum of choices available to the Government regarding what types of assets to tax and how to stage the timing of introduction.

What to tax?	• Land and buildings (except the family home) • Intangible property (e.g. intellectual property) • Assets held by businesses • Shares and other equites	Similar to most countries, except that many countries also tax collectibles
When to tax?	• Only collect tax when an asset is sold or transferred (with some exceptions e.g. managed funds)	Similar to all other countries
When to defer tax? *Rollover (no tax is collected until the asset is sold again)*	• Small business assets (selling one asset to buy another) • Some transactions related to Māori collectively-owned assets (e.g. recovery of ancestral land lost through Crown action) • Inheritance • Transfer of relationship property (e.g. divorce) • Business reorganisations (e.g. sole trader putting business into a company)	Very similar to most other countries that have rollover relief Many countries have no small business concession.
From when to tax gains? (April 2021)	• Only tax gains that are made after 'Valuation Day'. There are various ways to determine what the value was at that date e.g. ratings valuation, professional valuation, and default valuation rules • The Group proposes allowing up to 5 years to get a professional valuation	Same as some countries (e.g. Canada), but other countries only tax assets purchased after the tax came into effect (e.g. Australia)
How to tax?	• Capital income treated the same as other income and taxed at appropriate income tax rates (e.g. 28% for companies and marginal rates for individuals), with no adjustment for inflation	Low end for gains earned by companies, but higher end for gains earned directly by individuals
How to deal with losses?	• Allow most losses, once the asset is sold, to be offset against other taxable income. • To prevent gaming of the tax system, 'ring-fence' some types of losses to offset only against other capital gains • No losses for land/property held for private use	What is recommended is relatively generous compared to other countries and would limit the effect the tax would have on risk-taking

Rationale for extending capital income taxation – improving the fairness of the tax system

Reason #1. Shift more of the tax paid to wealthier households

Additional capital income tax estimated to be paid as a share of disposable income[1]

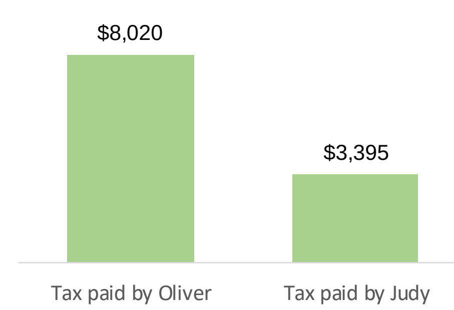


Reason #2. Help fix the current problem of people paying different amounts of tax if they earn income in different ways

Example:

In 2018, Oliver earned $50,000 in wages. He paid $8,020 in tax on this income.

Judy earned $25,000 from part-time work. She also sold shares in a business, and received non-taxable income from a capital gain of $25,000. Under current law, Judy will pay $3,395 in tax.



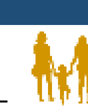
Other key recommendations

Business and Housing Measures[2]

- **Allow businesses to claim depreciation expenses on buildings** – encourages more business investment (range of options)
- **Allow businesses to deduct expenses for "black hole" expenditure** – encourages innovation and entrepreneurship
- **Allow businesses to keep losses when the owner changes** – makes it easier for small companies to expand
- **Remove residential loss ring-fencing** – recognises that gains would be taxed and could reduce upward pressure on rents

Environmental Taxation

- **Framework:** Report introduces a draft framework for deciding when to use tax instruments (e.g., emissions/resource use must be measurable)
- **Opportunities:** Group identifies four areas where tax could improve environmental outcomes. These are currently being worked on through seperate Government work programmes
  - Greenhouse gases
  - Water pollution & abstraction
  - Solid waste
  - Road transport



Personal Income and Savings Measures[2]

- **Income tax changes** (range of options, including a tax-free threshold – preferred option is to increase the bottom tax threshold, with a possible increase in second marginal tax rate)
- **KiwiSaver tax exemption** – remove tax on employer KiwiSaver contributions for lower income KiwiSavers
- **KiwiSaver member tax credit –** increase Government contributions to all KiwiSavers
- **Reduce KiwiSaver PIE rates** – give lower income KiwiSavers the same benefit as those in the highest tax bracket

Bringing Māori Perspectives into Tax Policy

- The Tax Working Group engaged with Māori on how tikanga might enhance tax policy
- There was support for this approach - many Māori recommended it should have wider application
- The Tax Working Group recommends the Treasury further develop *He Ara Waiora* in the context of the Living Standards Framework

Next steps

Make decisions *Apr 2019*	Announce and consult *Apr – Aug 2019*	Introduce legislation *Oct – Dec 2019*	Legislation passed *Jul 2020*	Implementation *Apr 2021*

1. Source: Stats NZ (HES 2015); the Treasury. This is estimated tax paid over and above current taxes. Estimates are based on the share of total household net worth that could be subject to capital gains taxation by household net worth decile, and projected revenue from the taxation of capital gains. Estimates for revenue from capital gains taxation are for the fifth year after introduction, discounted to tax year 2021/22 when the extension of capital gains tax is assumed to take effect. See the Tax Working Group's Final Report. Estimates are preliminary and indicative.
2. These measures are proposed by the Group as part of revenue-neutral packages, together with a broad extension of capital gains taxation

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Working Group Final Report findings

February 2019

Overview

Context

- The Government established the Tax Working Group (TWG) to find ways of improving the structure, fairness and balance of the tax system
- The TWG published its Interim Report in September 2018
- The TWG has now provided the Government with its Final Report. It will be publically released on 21 February 2019

Purpose of this presentation

- Overview key issues and findings in the Final Report
- Clarify next steps after the final report is released
- Outline Government’s approach to responding to the Final Report and key messages

Topics covered in the report

Key topics in the Final Report

- Extending capital income taxation – including detailed design proposal
- Environmental taxes
- Taxation of business and savings
- Personal income taxation
- Revenue-neutral packages

Topics that it reaffirms Interim Report findings on

- GST and financial transaction taxes
- Corrective taxes
- The treatment of charities
- The administration of the tax system
- The integrity of the tax system
- International income taxation
- The future of work
- Housing

Taxing capital income (capital gains)

- **All members** of the Group recommend extending capital income taxation, although there is disagreement about the scope of the extension.

- **Majority**: Recommends a broad extension that applies to most asset classes.
  - Forms basis of detailed proposal in Volume 2 of the report
  - Projected to raise $8.3 billion in first five years (2021/22 - 2025/26)

- **Minority**: Recommends a limited extension that just applies to gains from selling residential rental properties.

- The Group has also made it clear a spectrum of choices is available when considering an extension of capital income taxation. These choices include which types of assets should be subject to the tax.

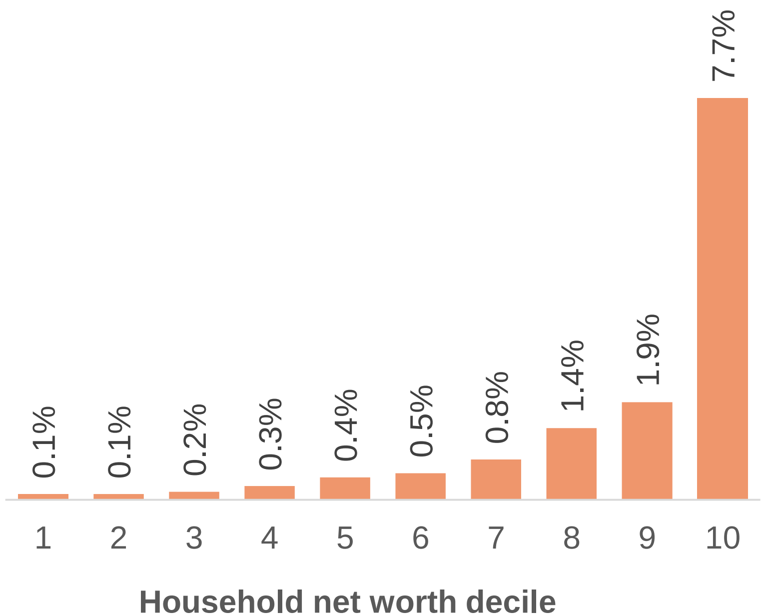
Extending capital income taxation
What the Group is proposing

Topic	TWG s recommendation (majority)	International comparison
What to tax?	• Land and buildings (except the family home) • Intangible property (e.g. intellectual property) • Assets held by businesses • Shares and other equites	Similar to most countries, except that many countries also tax collectibles
When to tax?	• Only collect tax when an asset is sold or transferred (with some exceptions e.g. managed funds)	Similar to all other countries
When to defer tax? *Rollover (no tax is collected until the asset is sold again)*	• Small business assets (selling one asset to buy another) • Some transactions related to Māori collectively-owned assets (e.g. recovery of ancestral land lost through Crown action) • Inheritance • Transfer of relationship property (e.g. divorce) • Business reorganisations (e.g. sole trader putting business into a company)	Very similar to most other countries that have rollover relief Many countries have no small business concession.
From when to tax gains? (April 2021)	• Only tax gains that are made after 'Valuation Day'. There are various ways to determine what the value was at that date e.g. ratings valuation, professional valuation, and default valuation rules • The Group proposes allowing up to 5 years to get a professional valuation	Same as some countries (e.g. Canada), but other countries only taxed assets purchased after the tax came into effect (e.g. Australia)
How to tax?	• Capital income treated the same as other income and taxed at appropriate income tax rates (e.g. 28% for companies and marginal rates for individuals), with no adjustment for inflation	Low end for gains earned by companies, but higher end for gains earned directly by individuals
How to deal with losses?	• Allow most losses, once the asset is sold, to be offset against other taxable income. • To prevent gaming of the tax system, 'ring-fence' some types of losses to offset only against other capital gains • No losses for land/property held for private use	What is recommended is relatively generous compared to other countries and would limit the effect the tax would have on risk-taking

Extending capital gains taxation
Key rationale – improve fairness

Reason #1: Shift more of the tax paid to wealthier households

Additional capital income tax estimated to be paid as a share of disposable income[1]



Source: Stats NZ (HES 2015); the Treasury

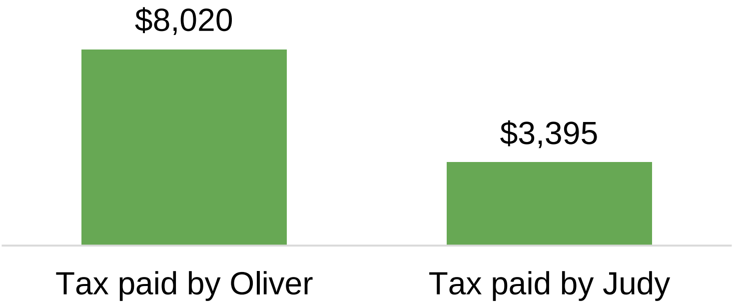
Reason #2: Help fix the current problem of people paying different amounts of tax if they earn income in different ways

Example:

In 2018, Oliver earned $50,000 in wages. He paid $8,020 in tax on this income.

Judy earned $25,000 from part-time work. She also sold shares in a business, and received non-taxable income from a capital gain of $25,000.

Under current law, Judy will pay $3,395 in tax.



[1] Estimates are tax paid over and above current taxes. Estimates are based on the share of total household net worth that could be subject to capital gains taxation by household net worth decile, and projected revenue from the taxation of capital gains. Estimates for revenue from capital gains taxation are for the fifth year after introduction, discounted to tax year 2021/22 when the extension of capital gains tax is assumed to take effect. See the Tax Working Group's Final Report. Estimates are preliminary and indicative.

Complementary measures
Personal and business tax options

The Group has presented options for potential tax measures to include in a revenue-neutral package alongside extending capital income taxation

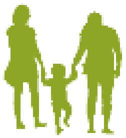
Business tax and housing measures

Allow businesses to claim depreciation expenses on buildings – encourage more business investment (range of options)

Allow business to deduct expenses for “black hole” expenditure – encourage innovation and entrepreneurship

Allow businesses to keep losses when the owner changes – make it easier for small companies to expand

Remove residential loss ring-fencing – recognising that gains would be taxed and could reduce upward pressure on rents



Personal income tax and saving measures

Income tax changes (range of options, including a tax-free threshold – preferred option is increase in bottom tax threshold, with a possible increase in second marginal tax rate)

▪**KiwiSaver tax exemption** – remove tax on employer KiwiSaver contributions to lower income KiwiSavers

KiwiSaver member tax credit – increase Government contributions to all KiwiSavers

Reduce KiwiSaver PIE rates – give lower income KiwiSavers the same benefit as those in the highest tax bracket

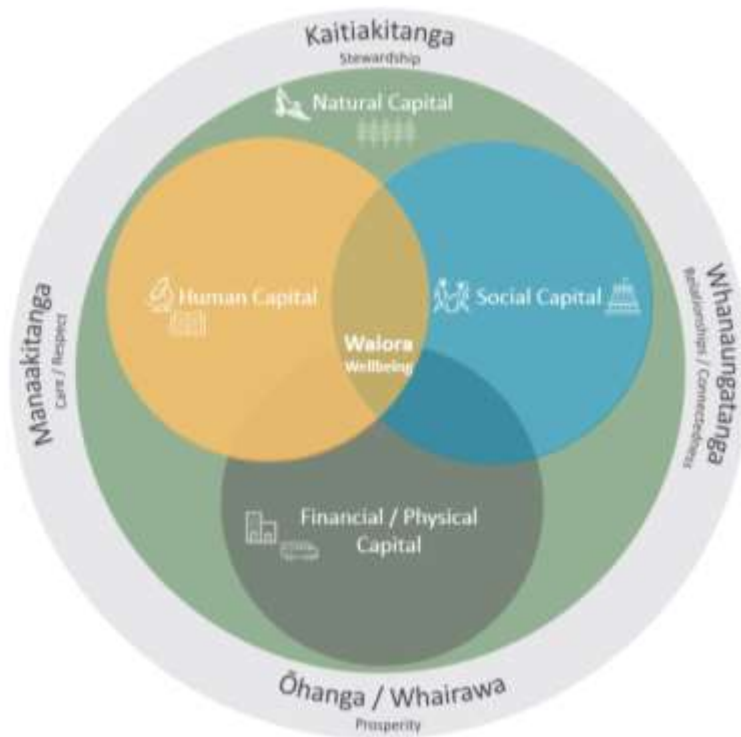
Environmental taxation

- Tax instruments are a useful tool for improving environmental outcomes – ensure we take account of the cost of our actions on the environment
- **Framework:** Report introduces a draft framework for deciding when to use tax instruments (e.g., emissions/resource use must be measurable)
- **Opportunities:** Group identifies five areas where tax could improve environmental outcomes. These are currently being worked on through seperate Government work programmes
  - *Greenhouse gases* ⇒ *ICCC, Zero Carbon Bill*
  - *Water pollution & abstraction* ⇒ *Freshwater work programme*
  - *Solid waste* ⇒ *Waste levy review*
  - *Road transport* ⇒ *The Congestion Question*
- **Concessions:** New tax concessions (e.g., e.g., QEII expenditure, fringe benefit tax on employer-provided public transport), and review of current tax measures in some industries to ensure not harming natural capital (agriculture, forestry, petroleum mining)

Māori perspectives and interests

- TWG engaged with Māori on how **tikanga might enhance tax policy**
  - Strong support for this approach - many Māori recommended it should have wider application
  - TWG recommends The Treasury further develop *He Ara Waiora* in the context of the Living Standards Framework

He Ara Waiora – A Pathway Towards Wellbeing



- **Extending tax on capital income** was identified through the Māori engagement process as having potentially significant impact
  - Report identifies some areas related to Māori collectively-owned assets where taxing capital income would not be consistent with the policy intent of the change
  - Informed by engagement, TWG recommends some types of transactions relating to these assets warrant specific treatment (eg. recovery of ancestral land lost through Crown action)

Next steps

April 2019***** *****subject to consultation between coalition and confidence and supply parties	Cabinet decisions on Group's recommendations
April to August 2019	Consultation on government proposals (if any)
October - December 2019* *additional time to incorporate legislative package	Bill introduced
July 2020	Legislation passed and enacted
April 2021	Implementation

Key messages

- The Government set up the TWG to improve the fairness and balance of the tax system, and encourage more productive investment. The final decisions will be based on an overall package that meets that goal.
- There are many options for the Government’s final package. We suggest that any revenue generated from the Group’s recommendations would be recycled into measures designed to increase the income of New Zealanders and to support businesses through the changes in the tax system.
- The Government is currently considering the recommendations of the TWG. Decisions will be made in the coming months. No changes from these decisions will come into effect until after the 2020 election.
- We propose that all requests for comment on the report be referred to the Minister of Finance and the Minister of Revenue.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Tax Working Group final report – officials' companion advice

Date:	1 February 2019	**Report No:**	T2019/113 IR2019/041
		File Number:	MS-9-1

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report.	7 February 2019
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report.	7 February 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Matthew Gan	Tax Specialist, The Treasury	s9(2)(a)	N/A (mob)	
Mark Vink	Manager, The Treasury		s9(2)(a)	✓
Emma Grigg	Policy Director, Inland Revenue			

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Tax Working Group final report – officials' companion advice

Executive Summary

This report has been prepared to accompany the Tax Working Group's (TWG) final report which was delivered to you today. The purpose of our report is two-fold:

1. To summarise officials' high-level views on the key recommendations of the final report; and
2. To seek your direction on how we can best assist you in delivering a package of potential tax reforms to enact legislation by mid-2020.

Officials' high-level views on the TWG final report

This report should be read in conjunction with our report of 14 December on the key reform measures being considered by the TWG (T2018/3429, IR2018/800 refers). Our views from that report still hold. Because we intend to provide you with more targeted advice on the key recommendations over the course of February, we have kept the discussion relatively brief in this report.

In summary:

	Recommendation	Officials' high-level view
Capital	The majority of the TWG (8 members) support a broad extension of the taxation of capital gains. Projected to raise revenue of $8.3 billion in first five years following introduction.	• Substantially improves the fairness, sustainability and integrity of the tax system. • Some negative impact on productivity and efficiency (unless accompanied by complementary productivity and efficiency-enhancing measures), and adds complexity to the tax system.
	A minority of the TWG (3 members) would limit the extension to residential rental property. Projected to raise revenue of $2.8 billion in first five years following introduction.	• Much less improvement to the fairness, sustainability and integrity of the tax system than the majority recommendation. • Less negative impact on productivity and efficiency, and adds less complexity, than the majority recommendation,

Environmental	The TWG has developed a policy framework for assessing when to apply environment taxes and highlighted specific areas where there is scope to use them.	• Largely supportive of the recommendations and work is already underway in a number of areas.
Business measures	Consider measures to support the productive economy, boost investment and reduce compliance costs, including: • Changes to the loss continuity rules; • Changes to the treatment of 'black hole' expenditure; • Reintroducing depreciation on buildings; and • Specific options to reduce business compliance costs.	
Retirement savings measures	Consider four potential measures to encourage people to save more for retirement through KiwiSaver.	• Measures would support lower income savers. If you wish to increase support for the lifetime welfare of lower-income households, changes to tax and welfare settings are likely to be more effective.
Personal income tax measures	Several options have been considered. The TWG only considered changes to personal tax settings, as welfare changes were beyond its scope.	• Consider changes to transfer settings alongside changes to personal tax settings once the Welfare Expert Advisory Group (WEAG) has reported back.

The projected revenue from a broad extension of the taxation of capital gains is $8.3 billion in the first five years following its introduction. The TWG has developed four revenue-neutral tax packages with a range of complementary revenue-negative measures to illustrate the choices available to the Government depending on its priorities. The revenue-negative measures comprise a range of options covering personal tax, retirement savings, and business and housing measures.

Government decisions on the environmental and ecological recommendations of the TWG are not expected to impact the fiscal parameters of the potential tax package.

Delivering a package of potential tax reforms to enact legislation by mid-2020

In order to meet the Government's timeline for enacting any significant tax-reform by mid-2020 (to apply from 1 April 2021), you will need to make final policy decisions on key elements of proposed reforms over the next two months so that Cabinet approval can be sought in April and public consultation can begin through the release of a discussion document around May.

The work in developing a tax package can be split into two broad interconnected workstreams:

1. Choices in extending the taxation of capital gains; and
2. Choices on a tax package including which complementary revenue-negative measures to adopt.

The choices you make in extending the taxation of capital gains will determine the quantum of revenue you have to spend on any complementary revenue-negative measures. They may also impact the focus of any complementary measures you wish to adopt in seeking to improve the structure, fairness and balance of the tax system.

To assist you in developing a tax package, we propose to provide you with a series of reports over February and early March and will discuss these further with you on 7 February. The initial reports will ask a series of questions that will help us develop the key design parameters for the extension of the taxation of capital gains and the wider tax reform package.

We have also noted some initial questions in this report that the Minister of Finance may wish to discuss with officials at a scheduled meeting on 7 February (summarised in Annex A). We appreciate you may not yet be in a position to provide direction on many of these questions. However, any guidance you can provide at this stage will help us in tailoring future advice to assist you in the decision-making process.

In developing a tax package, careful consideration needs to be given to the administrative implications of the package, especially given the significant amount of change associated with Business Transformation. We will provide advice on administrative implications in our ongoing reporting.

Table of recommendations

The TWG has made many recommendations in the final report. This report only provides high-level comment on some of those recommendations. We will provide a table summarising our high-level views on all the TWG recommendations (excluding the extension of the taxation of capital gains) in the week of 4 February. We will discuss the TWG recommendations in respect of an extension of the taxation of capital gains in a separate report in advance of the Joint Ministers' meeting on 12 February.

Recommended Action

We recommend that you:

a **note** the contents of this report.

Noted/Not noted *Noted/Not noted*

b **discuss** the report with officials on 7 February.

c **indicate** any initial views on the questions in Annex A.

Mark Vink
Manager
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Tax Policy Report: Tax Working Group final report – officials' companion advice

Purpose of Report

1. This report provides officials' high-level advice on the key recommendations in the Tax Working Group (TWG)'s final report, and seeks your initial steers on where you would like further advice, and how you would like us to engage with you over the coming months.

2. The report is structured as follows:

Pages	Topic	What is covered
6 to 7	**Update on TWG's Recommendations**	Update on TWG's recommendations since our initial advice provided to you on 14 December 2018
7 to 11	**Overview of TWG's Key Recommendations**	Overview of TWG's key recommendations and officials' high-level views
12 and Annex A	**Next steps**	Summarises the questions for Ministers in the report into a draft agenda for the meeting with the Minister of Finance on 7 February

3. This report accompanies the following documents also provided to you on 1 February:
   - The TWG's final report; and
   - The draft Cabinet paper for the TWG's final report and related briefing material.

4. We are currently preparing separate reports on:
   - s9(2)(f)(iv)
   - Options to reduce compliance costs for businesses to be delivered in the week of 4 February;
   - A table summarising our high-level views on all the TWG recommendations (excluding the extension of the taxation of capital gains) to be delivered in the week of 4 February;
   - Advice commissioned by the Minister of Revenue, including a comparison of capital gains tax regimes across countries, the economic performance in countries that have introduced a capital gains tax, and the distributional impact of taxing capital gains; and
   - The TWG recommendations in respect of an extension of the taxation of capital gains in advance of the Joint Ministers' meeting scheduled for 12 February.

5. We propose to discuss this report with the Minister of Finance on 7 February. Questions for Ministers are noted throughout this report for discussion at that meeting and summarised in a draft agenda at Annex A.

Update on TWG's Recommendations

6. We reported to you on 14 December 2018 on the key reforms being considered by the TWG. Since then, there have been two major developments that have affected the TWG's overall recommendations in its Final Report:

   - Revenue from a broad extension of the taxation of capital gains is now projected to be $8.3 billion in the first five years following introduction, down from $10 billion in the 14 December report. This revision was made because of additional information received by officials and refinement of the modelling approach.[1] In response, the TWG has reduced the size of personal income tax reductions in its illustrative revenue-neutral packages.

- A minority of the TWG (three members) has recommended that the extension of the taxation of capital gains be limited to residential rental property. This is discussed further on page 8 below.

Overview of TWG's Key Recommendations

Majority recommendation – broad extension of the taxation of capital gains

7. The majority of the TWG's members have recommended a broad extension of the taxation of capital gains, as part of a package including complementary revenue-negative measures to be determined by the Government depending on its priorities.

8. Officials consider that a broad extension of the taxation of capital gains is the most effective way to meet the Government's objectives to improve the fairness, sustainability and integrity of the tax system, within the scope of the TWG's terms of reference. In particular, it would:
   - Improve fairness, by raising taxes on income that is currently under-taxed and increasing the progressivity of the tax system;
   - Improve sustainability, by broadening the tax base and ensuring the revenue base remains resilient to future structural changes; and
   - Improve integrity, by reducing opportunities for tax planning and tax avoidance stemming from the capital/revenue boundary and the difference in the company tax rate and top personal tax rate.

9. A broad extension of the taxation of capital gains should also increase the neutrality of investment decisions by reducing the extent to which tax settings bias investment decisions. This will lead to a more efficient allocation of capital in the economy which by itself would improve productivity.

10. On the other hand, there are some costs associated with a broad extension of the taxation of capital gains. These stem from the resulting lock-in effects[2], additional compliance costs, and higher levels of taxation of savings and investment. These costs mean that, on its own, an extension of the taxation of capital gains will have some negative impact on efficiency and productivity, and add complexity to the tax system. We would not expect the negative impact on efficiency and productivity to be large in aggregate, but some sectors will be more affected than others.

11. The extent to which a broad extension of the taxation of capital gains contributes to each of the Government's different objectives will depend on its design and how the revenue raised is used. There will be important trade-offs between objectives. For example, if the Government's overriding priority were for changes in the tax system to:
   - <u>Reduce inequality</u> – revenue-negative measures could be focussed on supporting lower-income individuals;
   - <u>Enhance efficiency and productivity</u> – revenue-negative measures could be focussed on improving business taxation to offset any negative effects on productivity from a broad extension of the taxation of capital gains.

[1] The revenue from a broad extension of the taxation of capital gains is based on the TWG's design of a capital gains tax and will therefore change depending on the final design of the extension. The revenue may also change if newer information comes to light or through further quality assurance.

[2] For assets that have increased in value, the tax liability is triggered when the assets are sold (or deemed to be sold). This may tend to lock taxpayers into existing assets instead of them selling to acquire preferred new assets.

Minority recommendation – limit extension of taxation to residential rental property

12. A minority of the TWG's members have recommended that the extension of the taxation of capital gains be limited to residential rental property (with no further extension at this point).

13. Officials consider that the minority recommendation would achieve the Government's objectives of improving the fairness, sustainability and integrity of the tax system to a significantly lesser extent than the broad extension of the taxation of capital gains recommended by the majority of the TWG's members. In particular, it would:
    - Do much less to improve fairness and reduce inequality, as it would leave capital gains from non-residential capital assets – whose ownership is highly concentrated among higher-wealth households – untaxed;
    - Do less to improve sustainability, as it would extend the tax base to a lesser extent, and therefore do less to ensure the revenue base remains resilient to future structural changes and
    - Do much less to improve integrity, as there would still be significant opportunity for tax planning and tax avoidance to benefit from the capital/revenue boundary and the difference in the company tax rate and top personal tax rate.

14. The minority recommendation would also raise less revenue than the majority recommendation ($2.8 billion rather than $8.3 billion over five years). This means that there would be less revenue to fund complementary revenue-negative measures to help meet the Government's objectives.

15. However, the minority recommendation would have a less negative impact on productivity than a broad extension of the taxation of capital gains, unless a substantial part of the additional revenue raised under a broad extension of the taxation of capital gains is used to finance productivity enhancing measures. This is because it would have a smaller impact on the returns to saving, investment and entrepreneurship. Taxing capital gains earned through land, as opposed to other forms of capital assets, is also likely to create less economic distortions as land is in fixed supply.

16. We will provide you with additional comment on the majority and minority recommendations in our report on designing an extension of the taxation of capital gains (in advance of the Joint Ministers' meeting on 12 February).

Phasing in or partial extensions

17. The TWG has noted that the Government could consider phasing-in a broad extension of the taxation of capital gains, or extending the taxation of capital gains to some assets but not others.

18. With regards to partial extensions, officials consider this would be generally less effective than a broad extension in achieving the Government's objectives for the reasons noted above on the minority recommendation.

19. With regards to phasing, officials note that, as previously advised, the timeline for implementing the broad extension of the taxation of capital gains by 1 April 2021 is very tight. Officials can meet the timeline, but it brings implementation risks of needing to make further legislative changes in future, which would impose higher uncertainty and compliance costs on taxpayers. As we have previously advised, the introduction of legislation until mid-2020 with effect from 1 April 2022 would substantially reduce these risks.

20. However, we have also given further consideration to whether phasing-in a broad extension of the taxation of capital gains would be an alternate way to reduce these implementation risks while still extending taxation to some assets from 1 April 2021. The most feasible phasing option would be to extend taxation to residential rental property (or residential property) from 1 April 2021, and to other asset classes (such as rural, commercial and industrial property, shares, business assets and managed funds) from 1 April 2022 or 1 April 2023 onwards. Other phasing options are unlikely to reduce risks compared with a broad extension of the taxation of capital gains from 1 April 2021.

21. We will provide you with additional comment on phasing in our report on designing an extension of the taxation of capital gains (in advance of the Joint Ministers' meeting on 12 February).

> **Question for Ministers**
>
> - What are Ministers' initial thoughts on the timing of introduction of a tax reform package (including the extension of the taxation of capital gains)?
>   a. Implement a tax reform package from 1 April 2021
>   *or*
>   b. Implement a tax reform package from 1 April 2022
>   *or*
>   c. Implement the extension to residential rental property from 1 April 2021, and to any other asset classes from 1 April 2022 or 1 April 2023.

Environmental and ecological outcomes

22. The TWG has developed a policy framework for assessing when environmental taxes could be usefully applied, and has highlighted specific areas where there is greater scope to use environmental taxes.

23. Officials are largely supportive of these conclusions, and note that work that addresses the TWG's specific recommendations is already underway in a number of areas.

The taxation of business

24. The TWG has made several recommendations on the taxation of business. Some of these were included in the TWG's interim report – such as recommendations against reducing the company tax rate, or introducing a progressive company tax. Since then, the TWG has made further recommendations to support the productive economy, boost investment, and reduce compliance costs. These include:
    - Making changes to the loss continuity rules;
    - Making changes to the treatment of 'black-hole' expenditure;
    - Considering the reintroduction of depreciation deductions for buildings; and
    - Examining specific options to reduce business compliance costs.

25. s9(2)(f)(iv)

26. We are preparing a report on options to reduce business compliance costs to be delivered to you in the week of 4 February.

Questions for Ministers

- Do Ministers wish to commission any particular advice on any of the business measures? Is there anything else Ministers would like to consider?

Retirement savings

27. The TWG has recommended the Government consider increasing tax benefits for low- and middle-income earners (or those on parental leave) provided through KiwiSaver to encourage people to save more for their retirement, and has proposed four potential measures to do so (summarised in Annex A).

28. The suggested measures would support savers, especially those on lower incomes, and could be used to offset any additional taxes on savings brought about by a broad extension of the taxation of capital gains. However, officials consider that none of these measures are likely to significantly increase the amounts that individuals contribute to their KiwiSaver funds. If the Government's objective is to increase support for the lifetime welfare of lower-income households more generally, we consider that changes to tax and transfer settings would be more effective than these KiwiSaver measures.

Question for Ministers

- Do Ministers wish to commission any particular advice on any of the KiwiSaver measures? Is there anything else Ministers would like to consider?

Personal income tax

29. The TWG noted that any changes to personal income taxation would need to reflect the objectives of the Government:
    - If the Government wishes to improve incomes for very low income households, the TWG considers that the best means of doing so is through welfare transfers.
    - If the Government wishes to improve incomes for certain groups of lower-to-middle-income earners, such as full-time workers on the minimum wage, the TWG considers that changes to personal income taxation may be a better option.

30. The TWG also considered a range of options to increase the progressivity of the personal tax system (summarised in Annex A). The TWG has a preference for increasing the bottom tax threshold – potentially combined with an increase in the second marginal tax rate – over introducing a tax-free zone.

31. Officials consider that the appropriate design of any changes to personal income tax settings depends on the Government's objectives.

32. The TWG has not focused on personal income tax settings at middle-to-upper-income levels, but the Government could consider investigating changes in all marginal rates and thresholds to increase efficiency and productivity.

33. Officials recommend you consider changes to transfer settings (i.e., benefits and credits) alongside changes to personal tax, and that you defer any decisions in this regard until after Budget 2019. This would allow time to take account of the WEAG's recommendations and to develop an integrated personal tax and welfare reform package.

34. s9(2)(f)(iv)

Question for Ministers

s9(2)(f)(iv)

- Are Ministers supportive of the option of deferring decisions in this regard until after Budget 2019 to account of the WEAG's recommendations?

Timelines

35. If Ministers want to enact legislation for a potential tax reform package before the 2020 General Election, legislation would need to be introduced by November 2019. Before this, there would need to be consultation on detailed design decisions, which would need to start around May with the release of a Government discussion document.

36. An indicative timeline to achieve this is set out below:

February	• TWG Final Report published
	• Discussions with Joint Ministers on:
	  o Design details for extending the taxation of capital gains
	  o Overall package of measures

March	• Joint Ministers decisions on:
	  o Design details for extending the taxation of capital gains
	  o Overall package of measures

April	• Cabinet decisions on:
	  o Design details for extending the taxation of capital gains
	  o Overall package of measures

May	• Government announces overall package of measures • Discussion document released
August	• Cabinet decisions on final design details • Legislative drafting instructions issued

37. This timeline requires you to take a series of decisions on a large number of complex issues over the course of February and early March, in time for papers to be prepared to be taken to Cabinet in April. We propose to send you a series of reports throughout February to facilitate these decisions and to discuss this suggested process at the meeting with the Minister of Finance on 7 February.

Question for Ministers

- Are Ministers comfortable with the proposed timeline at paragraph 36?
- How best can officials can best engage with Ministers and Cabinet over the coming months?

Next steps

38. Officials are scheduled to meet with the Minister of Finance on 7 February to discuss this report. To help guide the discussion at the meeting, we have prepared the draft agenda in Annex A summarising the questions in this report. We appreciate you may not yet be in a position to provide direction on many of these questions. However, any guidance you can provide at this stage will help us in tailoring further advice to asset you in the decision-making process.

ANNEX A:

Draft agenda for discussion
Meeting with Minister of Finance – 7 February 2019

Early guidance on tax packages

1. What are Ministers' current views on the balance of potential objectives for a tax reform package? Is there any particular advice or information that we could provide to assist Ministers in considering the options to achieve these objectives?

2. What are Ministers' initial thoughts on the timing of introduction of a tax reform package (including the extension of the taxation of capital gains)?
   a. Implement a tax reform package from 1 April 2021
   or
   b. Implement a tax reform package from 1 April 2022
   or
   c. Implement the extension of the taxation of capital gains to residential rental property from 1 April 2021, and to any other asset classes from 1 April 2022 or 1 April 2023.

Revenue-negative measures

3. Do Ministers wish to commission any particular advice on any of the following revenue-negative measures? Is there anything else Ministers would like to consider?

Revenue measures	Rationale	Further work
Business and housing measures		
a. Allow businesses to claim depreciation expenses on buildings	Encourage business investment and improve efficiency of investment	
b. Allow businesses to deduct expenses for 'black hole' expenditure	Encourage innovation and entrepreneurship	
c. Allow businesses to keep losses when the owner changes	Make it easier for small companies to expand	
d. Options to reduce business compliance costs	Reduce compliance costs or businesses	Advice in preparation
e. Remove residential rental loss ring-fencing	Reduce upward pressure on rents and increase efficiency	
KiwiSaver measures		
f. Decrease lower KiwiSaver PIE rates	Encourage saving by lower-income earners	
g. Provide the maximum level of Member Tax Credits for those on parental leave	Provide support through KiwiSaver for those on parental leave	
h. Remove tax on employer contributions to lower-income KiwiSavers	Encourage saving by lower-income earners	
i. Increase the Member Tax Credit	Encourage saving through KiwiSaver	
Personal income measures		
s9(2)(f)(iv) [redacted]		

Revenue measures	Rationale	Further work
s9(2)(f)(iv)		

Interface with the welfare system

4. s9(2)(f)(iv)
5. Are Ministers supportive of the option of deferring decisions in this regard until after Budget 2019 to take account of the WEAG's recommendations?

Timelines and process

6. Are Ministers comfortable with the following timeline?

February	• TWG final report published
	• Discussions with Joint Ministers on:
	  ○ Design details for extending the taxation of capital gains
	  ○ Overall package of measures

March	• Joint Ministers decisions on:
	  ○ Design details for extending the taxation of capital gains
	  ○ Overall package of measures

April	• Cabinet decisions on:
	  ○ Design details for extending the taxation of capital gains
	  ○ Overall package of measures

May	• Government announces overall package of measures • Discussion document released
August	• Cabinet decisions on final design details • Legislative drafting instructions issued

7. How best can officials engage with Ministers and Cabinet over the coming months?

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Further information on TWG issues raised

Date:	5 February 2019	**Priority:**	Medium
Security level:	Sensitive	**Report number:**	IR2019/031 T2019/175

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	None
Minister of Revenue	**Note** the contents of this report	None

Contact for telephone discussion (if required)

Name	Position	Telephone	
Mark Vink	Manager, Tax Strategy, the Treasury	s9(2)(a)	
Phil Whittington	Senior Policy Advisor, Inland Revenue		

5 February 2019

Minister of Finance
Minister of Revenue

Further information on TWG issues raised

Purpose

1. This report responds to four issues raised by the Minister of Revenue at a meeting with officials:

   - What sort of economic effects have been experienced in other jurisdictions when capital gains taxes have been introduced.
   - Should a capital gains tax (CGT) rate be lower than other income tax rates to account for the fact that some capital gains represent a return to taking risk?
   - How the extension of taxation of capital gains recommended by the Tax Working Group compares with CGTs in other jurisdictions.
   - s9(2)(f)(iv) [redacted]

2. The Minister of Revenue also raised questions relating to the number of individuals who would be likely to report particular capital gains, among other distributional questions. Those questions will be addressed in a later report.

What sort of economic effects have been experienced in other jurisdictions when capital gains taxes have been introduced?

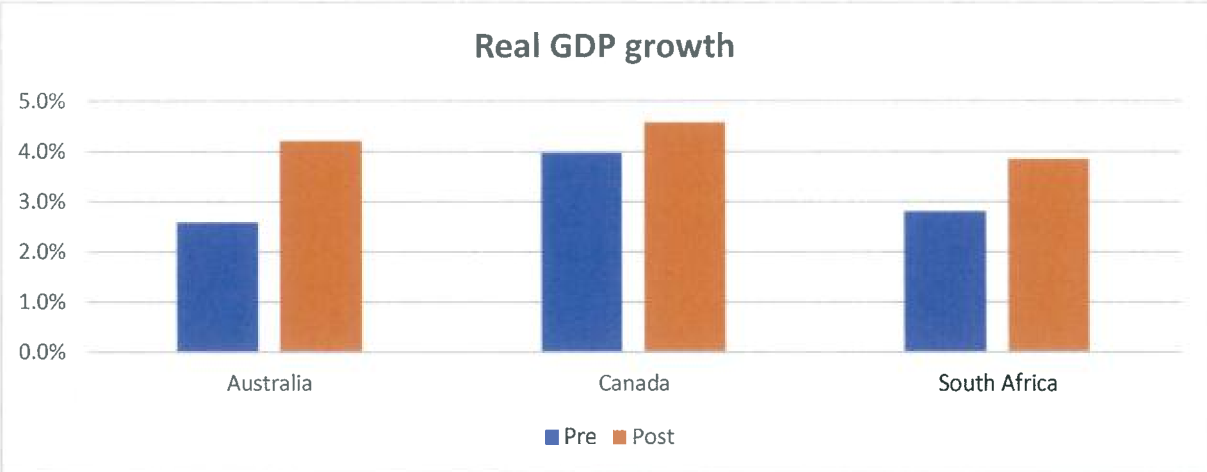
3. Officials' full discussion of the likely impacts of the capital gains tax is in a paper prepared for the Tax Working Group. That paper is appended to this note.

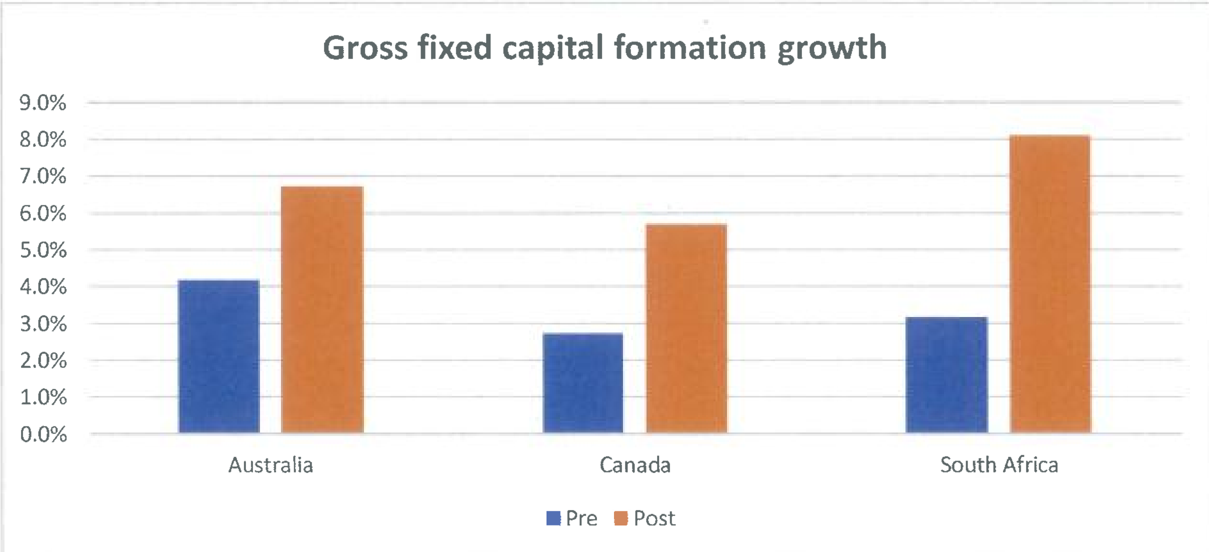
4. There is no comprehensive academic literature that compares economic performance based on the introduction of capital gains taxes. There are academic papers on the effects of changes in capital gains tax rates, and on the theoretical effects of capital gains taxes, but these are often focussed on questions like the extent of "lock-in" rather than aggregate economic performance.

5. The Minister of Revenue asked whether there have been any large effects on aggregate economic performance (in terms of GDP etc.) from the introduction of capital gains taxes. We have carried out a simple exercise comparing two measures of economic activity before and after the introduction of capital gains taxes. For Australia, Canada, and South Africa, we provide averages of annual gross fixed capital formation (GFCF) growth, and annual gross domestic product (GDP) growth, for five years prior to, and five years after (including the year of) introduction of a capital gains tax. Canada introduced its capital gains tax in 1972. Australia's CGT applies to gains from 20 September 1985, and South Africa introduced its CGT in 2001.

6. We do not recommend using this sort of analysis as evidence of a capital gains tax, but at the very least the high-level data show no outright reductions in gross fixed capital formation or GDP growth rates. Gross fixed capital formation was higher after the introduction of a CGT in Canada, South Africa, and Australia. Per capita GDP growth was higher in the five years after introduction in all three countries. We

emphasise that this is not a sophisticated analysis – it merely compares high-level averages in three countries. Further, we are not of the view that the fact that gross fixed capital formation and GDP were higher provides any evidence that the capital gains tax *stimulated* investment and growth. Rather it reflects the fact that there will have been other confounding factors that make any simple relationship impossible to disentangle. Other factors in the economy, such as the business cycle, are likely to dominate any effect from extending the taxation of capital gains. At the same time, some critics of extending the taxation of capital gains have at times seemed to suggest that doing so would do catastrophic things to the economy. That is not at all apparent from looking at headline numbers. Ultimately, the costs and benefits of taxing more capital gains will obviously depend on how the revenue is spent and the productivity gains that this provides.





Source: OECD

7. The fact that there is limited academic literature on the effects on national economic performance before and after the introduction of a CGT probably reflects the difficulty in disentangling any effects from a CGT from other national and international trends that are likely to have a larger impact.

8. With regard to New Zealand, officials are of the view that a capital gains tax is unlikely to have any large impact on aggregate economic performance that would be of a magnitude to show up in aggregate data, but it could be significant for some sectors. We also point to the forecast revenue that a CGT is expected to raise, relative to the size of the total economy. After ten years, extending the taxation of

capital gains is expected to raise 1.2% of GDP in tax revenue per annum. Our full discussion is in the attached paper.

Should a CGT rate be lower to compensate for the fact that some capital gains represent returns to risk?

9. Provided that the tax system treats positive outcomes and negative outcomes symmetrically, no part of the tax will "tax risk".

10. As an example, assume a risky venture can result in a capital gain of +$100 50% of the time, and a capital loss of ($100) the other 50% of the time. Such a venture would have a 1:1 risk-to-reward ratio.

11. Now assume that capital gains and losses are brought within the tax system. If the tax rate is 33% and the tax system allows losses to be offset against other income, then provided there is other income against which to use the loss, the post-tax positive outcome would be +$67, and the post-tax negative outcome would be ($67). The risk-to reward ratio is still 1:1.

12. The same is true for risks that are expected to return more than the possible loss. If the capital gain from a positive outcome is $1000, and the capital loss from a negative outcome is ($100), the risk-to-reward ratio is 1:10. With a 33% tax rate, the positive outcome after tax is +$670, and the negative outcome after tax is ($67). The risk-to-reward ratio is still 1:10.

13. In their submission to the Tax Working Group, the Angel Association New Zealand (which represents start-up investors) concluded that:

> a well-designed capital gains tax policy, which includes property, together with a carefully defined and described high growth start-up ecosystem and its ventures, would see resources channelled more efficiently and purposefully to support the success of these high risk, but high impact ventures. A capital gains tax, and a corresponding offset for capital losses, would allow early stage investors some respite from the inevitable failure of early stage investment.

14. We do not consider that by itself risk provides a case against taxing realised gains. However, it does provide a reason to be wary of extensive loss ringfencing. Extensive loss ringfencing will increase the chance that losses are not able to be used for tax purposes, or at least delay their use. In that case the loss ringfencing will have changed the risk-to-reward ratio.

How does the extension of the taxation of capital gains outlined by the TWG compare with CGTs in other jurisdictions?

15. An appendix attached to this report sets out how the extension of taxation of capital gains outlined by the TWG compares with CGTs in other jurisdictions on some of the major dimensions.

16. For capital gains earned in companies and distributed to individuals, New Zealand would be at the low end of effective tax rates due to imputation which relieves double taxation of income earned through companies. For capital gains earned directly by individuals, New Zealand would be at the higher end of tax rates, but a significant number of countries have rates in the range of 25 to 30%[1], and some countries such as Germany and Italy (except for shares and real estate held for a certain period), Ireland, and Denmark, tax capital gains at 33% or higher.

17. On capital loss ringfencing, the TWG are recommending as little of this as feasible, which would put New Zealand on the more liberal end of the spectrum, and (as discussed above) would treat risk more neutrally.

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[1] Harding, M. and M. Marten (2018), "Statutory tax rates on dividends, interest and capital gains: The debt equity bias at the personal level", OECD Taxation Working Papers, No. 34, OECD Publishing, Paris.

18. The rollover reliefs recommended are very similar to most other countries that have rollover reliefs.

19. The types of assets to be excluded are similar to most other countries, with perhaps the exception of collectibles, which many other countries include.

20. Many countries have no small business concessions, and for those that do, it is often to be consistent with the way these countries tax retirement savings, which in turn is influenced by their restriction of superannuation payments. That is, countries that do not provide universal superannuation often tax retirement savings in a concessionary way, and to be consistent with this retirement treatment any capital gains taxed on the sale of a small business to fund retirement is treated similarly. New Zealand is different from many of these countries in that it has a universal superannuation scheme that is not means tested, and does not have large retirement savings concessions.

s9(2)(f)(iv)

[redacted]

s9(2)(f)(iv)

[redacted]

Recommended action

We recommend that you **note** the contents of this report.

Noted

Noted

s9(2)(k)

[redacted]

Mark Vink
Manager, Tax Strategy
The Treasury

Phil Whittington
Senior Policy Advisor
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
TWG recommendations for NZ	33%	33%	28%	Not generally only for listed shares and other easily traded assets	Death Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt Rollover for small businesses (less than $5m of turnover) that reinvest in active assets	Main home Cars Personal use items and collectibles Trading stock	Retirement concession: lower KiwiSaver tax rates apply to the first $500,000 of capital gains made by business owners who sell a closely held active business they have owned for a certain period of time (e.g. 15 years) in order to retire once they reach retirement age (e.g. 60 years or older) or younger business owners if the capital gain is reinvested into a KiwiSaver scheme. Rollover for small businesses (less than $5m of turnover) that reinvest in active assets
Australia	47% (2% is medicare levy which applies to all income including capital gains)	23.5% (50% discount if held for 1 year by individuals or trusts)	30% large companies 27.5% medium companies 13.75% if applying 50% discount for small business assets owned for 1 year 15% rate for superannuation funds or 10% if the shares held for 1 year (33% discount)	Yes	Death Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt Rollover for small businesses that reinvest in active assets within two years	Main home Cars Personal use items acquired for less than AUD$10k (NZD $10.5k) Collectibles acquired for less than AUD$500 (NZD $525) Depreciating assets and trading stock (taxed under income tax rules at full rates) Pre-CTG assets acquired prior to 20 Sept 1985	4 types of small business concession. To qualify less than AUD$2m (NZD $2.1m) of annual turnover or less than AUD$6m (NZD $6.3m) of net CGT assets: Exemption if owner is aged over 55 has owned asset for at least 15 years and is retiring Exemption if funds put into the owner's superannuation scheme ($500k lifetime cap (NZD $525k)) 50% discount for small business assets owned for 1 year (can be combined with individual discount so taxed on only 25% of gain) Rollover for small businesses that reinvest in active assets within two years

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
Canada	53.5% (Average combined federal and state tax. 33% is federal tax. State personal tax is applied on same basis as federal)	26.75% (50% discount for Canadian residents)	13.4% (50% discount for Canadian residents including corporates. Based on an average combined federal and state rate of 26.8% of which 15% is federal)	Yes	Death (only to spouse or farm, forestry or fishing property to children) Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt Like-kind exchanges of tangible business assets	Main home Personal use items if market value is less than CAD$1,000 (NZD $1,107)	Exemption for capital gains realised by an individual from sale of shares in a closely held corporation up to a lifetime limit of CAD$848,252 (NZD $940k) in 2018, indexed to inflation A CAD$1 million (NZD $1.11m) lifetime exemption applies to farm and fishing property
Denmark[3]	55.8%	42% The first DKK52,900 ($11,825 NZD) of gains from shares (per spouse) is taxed at lower rate of 27%	22% Unlisted shares held by corporates are tax exempt	Yes Real estate capital losses are also ring-fenced to capital gains on real estate	[Unknown – no information could be found in English]	Private house that the owner has lived in Cars Private personal use items Inheritance tax applies to inheritances (not CGT)	None
France	53.9%	30% standard rate on shares. Reduced to 15% for shares if held for 2-7 years, 10.5% for shares held for 8+ years or 4.5% if SME shares are held for 8+ years 19% on real estate	28% on income up to €500k (NZD $834k), and 31% on income exceeding that amount	Yes	Divorce[4] Sole trader incorporates Transfers between wholly-owned companies in same group	Main home Gifts to close member of family under certain condition and under a certain threshold Gains derived from the sale of moveable assets under a threshold and subject to conditions Inheritance tax applies to inheritances (not CGT)	4.5% tax rate on capital gains tax on shares in SMEs held for at least eight years, provided the shares were acquired within 10 years of the creation of the SME.

[3] Denmark, France, Germany, Ireland, Italy, Japan, Spain, UK and US apply an inheritance tax on death (instead of the CGT).

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
Germany	47.5%	25% on shares 47.5% on other assets **NB:** real estate / housing is exempt if held for at least 10 years	30%	Yes for individuals	Divorce Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt Exchanges of tangible business assets (no like-kind restriction)	Main home Other real estate / housing owned for at least 10 years Other private assets owned for at least 1 year Collectibles held for at least 1 year (still taxed if sold as part of a business – e.g. of dealing collectibles) Inheritance tax applies to inheritances (not CGT)	None
Ireland	48%	33% (CGT rate is lower than top personal rate)	33% (CGT rate is higher than company rate of 12.5%) 12.5% or 15% CGT rates for Venture Capital funds	Yes	Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt	Main home Private motor cars and other wasting chattels Annual exempt amount of first €1,270 (NZD $2,119) of gains is exempt from CGT. Moveable property, where the gain is less than €2,540 (NZD $4,238) Animals Certain shareholdings by corporate shareholders No CGT on death and inherit at market value (but inheritance tax may apply)	Retirement exemptions for business assets (including farms) held for at least 10 years and transferred by a person aged over 55 Capped at €750k (NZD $1.25m) of consideration unless transferred to the person's child. Lower limits apply for persons aged over 66 (€500k (NZD $834k) limit or €3m (NZD $5m) limit if transferred to your child). Entrepreneur relief: 10% rate on shares (minimum 5% shareholding) and business assets held by individuals for at least 3 years and who spent at least 50% of their work time working in the business. Limited to a lifetime cap of €1m (NZD $1.67m) of gains.

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
Israel	50% (3% is surtax which applies to income from all sources)	20% on real estate (but inflationary component of gain is exempt from tax) 25% on domestic listed shares (but inflationary component is exempt from tax) Offshore listed shares are taxed at 20% or 25% tax rates	23% (but inflationary component of gain is exempt from tax)	Yes	Death Gifts Transfers between wholly-owned companies in same group Reinvest insurance proceeds 50% reduction in tax if compulsory acquisition by Govt	Main home (exemption can only be used once every 18 months and only applies to the extent the home sells for less than NIS 4.5m (NZD $1.8m))	None
Italy	43%	43% generally 26% rate on portfolio shares **NB:** real property is exempt if held for at least 5 years (or inherited)	24%	Yes for individuals	No rollover relief	Main home Other real property held for at least 5 years (or inherited) by individuals Inheritances and gifts are subject to Inheritance tax and Gift tax (not CGT)	None
Japan	55.8%	20% on shares 20% on long-term gains on real property (39% if short-term gains)	30%	Not generally only for shares owned by individuals	Reinvest insurance proceeds or compulsory acquisition by Govt Transfers between wholly-owned companies in same group Like-kind exchanges of tangible assets	Personal property for daily living (such as furniture and clothes) Inheritances and gifts are subject to Inheritance tax and Gift tax (not CGT)	None

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
Mexico	35%	35% 10% on listed shares	30%	Not generally only for shares	Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt	Main home Inheritances are not subject to tax Gifts, but limited to MXN$88k ($6,777 NZD) of gifts unless gifted to your spouse, parent or children	None
Norway	38.2%	22% 31.68% on gains from shares	22% Exemption for shares held in another company	No	Death Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt	Main home (if owned for at least one year) Vacation home (if owned for at least five years)	None
South Africa	45%	18% (60% discount for individuals)	22.4% (20% discount compared to 28% company tax rate)	No	Death (only transfers to spouse) Divorce Reinvest insurance proceeds or compulsory acquisition by Govt Transfers between wholly-owned companies in same group	Main home exempt up to R$2m (NZD $210k) Personal use assets of an individual not used mainly for purposes of trade, subject to exclusions Annual exempt amount where the first R40k (NZD $4,298) is exempt from capital gains tax	Retirement concession: A small lifetime exemption of R1.8m (NZD $190k) of capital gains from active assets of small businesses that have less than R10m (NZD $1.07m) of total assets. The exemption applies upon death or retirement (aged over 55 or sick) of the small business owner / operator

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
Spain	43.5%	23% top rate Spain has special tax rates for investment income (including capital gains) which are: 19% for first €6k (NZD $10k) of investment income 21% for €6k to €50k 23% above €50k (NZD $83.5k)	25%	Yes	Divorce Sole trader incorporates Transfers between wholly-owned companies in same group	Main home (but only if sale proceeds used to pay off mortgage or reinvested into another main home) Inheritances and gifts that are subject to the Inheritance tax and Gift tax (not income tax)	None
Sweden	60.1%	30% generally 22% on main home 25% for individuals with unlisted shares	22% Exemption for shares held in another company (if the company owns at least 5% of the other company)	Yes	Death Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds	Main home taxed at reduced rates (approx. 22%) Gifts and family law related acquisitions Annual exempt amount of SEK $50,000 (NZD $8,084) gains on personal assets by individuals	None
Switzerland	36.1% (Average combined federal and canton tax. 11.5% is federal tax)	11.5% on business assets 6.25% on shares if shareholding is at least 10% and held for 1 year Gains on real property are taxed at various rates at canton level rather than federal level	8.5% Exemption for shares held in another company (if the company owns at least 10% of the other company) Gains on real property are taxed at various rates at the canton level rather than federal level	No	Death Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Exchanges of tangible business assets (no like-kind restriction)	An individual's non-business assets (but gains on real property are taxed at canton level rather than federal level)	None

Country	Top personal tax rate	Top personal CGT rate after applying discount	CGT rate for companies	Capital loss ringfencing	Rollover relief (main types)	Excluded assets (not subject to CGT)	Small business CGT concessions
UK	45%	20% generally (top CGT rate is lower than top personal rate) 28% on residential property and carried interest (8% surcharge) 10% rate on the first £10m (NZD $19.3m) of gains (lifetime cap) on shares held for at least 3 years in companies (excludes listed companies unless the shares were issued before the company was listed) or held for at least 1 year if person holds more than 5% of the shares in a company (which can be a listed company).	19% Exemption for shares held in another company (if the company owns at least 10% of the other company) 20% if the company sells UK residential property	Yes	Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt Exchanges of business assets (including goodwill and no like-kind restriction)	Main home Cars and passenger vehicles Wasting chattels except plant and machinery Annual exempt amount of £11,700 (NZD $22,578) of gains by individuals No CGT on death and inherit at market value (but inheritance tax may apply)	10% rate on the first £10m (NZD $19.3m) of gains (lifetime cap) on shares held for at least 3 years in companies (excludes listed companies unless the shares were issued before the company was listed) or held for at least 1 year if person holds more than 5% of the shares in a company (which can be a listed company). Exemption for gains on shares held for at least 3 years that qualify under the enterprise investment scheme. The investor has to hold less than 30% of the shares in the company. At time the shares were issued the company must be less than 7 years old, not have assets greater than £15m ($29m NZD) and fewer than 250 employees and has raised less than £15m of equity. Excludes the following industries: coal and steel production, farming, leasing, financial services or property development.
USA	46.3% (Average combined federal and state tax, 37% is federal tax)	20% rate for individuals who hold assets for 1 year 7.5% or 10% rates for shares in small companies (less than $50m of assets (NZD $73.2m) held for at least 5 years (limited to $10m (NZD $14.6m) or 10 times the cost of the shares)	26% (Average combined federal and state tax, 21% is federal tax)	Yes	Divorce Sole trader incorporates Transfers between wholly-owned companies in same group Reinvest insurance proceeds or compulsory acquisition by Govt Like-kind exchanges of real property (including residential property) or small business shares in companies	Main home (capped at US$250k (NZD $366k) of gains every 2 years) Gifts and bequests No CGT on death and inherit at market value (but inheritance tax may apply) 0% capital gains tax rate for long-term gains made by lower-income individuals / married couples	7.5% or 10% rates for shares in small companies (less than US$50m of assets (NZD $73.2m) held for at least 5 years (limited to $10m (NZD $14.6m) or 10 times the cost of the shares) Like-kind exchanges of real property (including residential property) or small business shares in companies

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Major Design Issues in the Taxation of Capital Gains

Date:	8 February 2019	**Priority:**	High
Security level:	Sensitive	**Report number:**	IR2019/061 T2019/246

Action sought

	Action sought	Deadline
Minister of Finance	**Note and discuss** the contents of this report	12 February 2019
Minister of Revenue	**Note and discuss** the contents of this report	12 February 2019

Contact for telephone discussion (if required)

Name	Position	Telephone
Mark Vink	Manager, the Treasury	s9(2)(a)
Paul Kilford	Policy Manager, Inland Revenue	

8 February 2019

Minister of Finance
Minister of Revenue

Major Design Issues in the Taxation of Capital Gains

1. This Report provides information and seeks direction from Ministers on a number of the main issues involved in designing an extension of capital gains taxation.

2. It is intended to allow Ministers to provide guidance to officials as they develop material for an eventual discussion document. Ministers are also invited to indicate areas where they need further information.

3. This report is the first of two on capital gains design. It includes questions on high-level design principles that officials would like to discuss with Ministers at the Joint Ministers' meeting scheduled for 12 February. Although it does not seek final decisions, the answers to these questions will be helpful for the drafting of the subsequent report on the detailed design recommendations of the TWG report, scheduled to be delivered to Ministers on or around 22 February.

Part A: Majority and the Minority Recommendations

4. The majority of the Group has recommended a broad extension of capital gains taxation. A minority has recommended that capital gains taxation be extended only to residential property other than the family home. The minority recommendation was further split between extension to residential rental property only or residential rental property plus second homes.

5. This part compares the majority and minority recommendations with respect to the Government's objectives.

6. As noted in previous reports, the majority recommendation affects the Government's objectives as stated in the terms of reference for the Tax Working Group. It would significantly increase progressivity and horizontal equity. It would improve the integrity and sustainability of the tax system. It would have mixed effects on efficiency and productivity. On one hand it would increase efficiency and productivity by evening out tax rates across activities. At the same time, however, it would create a "lock-in" effect that could deter efficient reallocations of capital. It would increase overall taxation of income from capital that would reduce investment, leading to lower productivity. In the absence of offsets, it is likely to reduce efficiency and productivity. But the overall effect on productivity depends crucially on how the revenue raised by the extension is returned to taxpayers as part of a package of complementary measures as well as the detailed design of the measure. It would increase compliance costs for taxpayers.

7. The minority recommendation would increase the horizontal equity and progressivity of the tax system but to a lesser extent than the majority recommendation. It would do little to improve the integrity of the tax system. On the other hand, the minority recommendation would have a less negative effect on efficiency and productivity and would avoid the compliance costs arising from a broad extension. However, it would also raise less revenue.

8. Overall, officials consider that the majority recommendation, if combined with complementary initiatives that improve efficiency and productivity such as the

business package of changes[1], would advance the Government's objectives for the tax system to a significantly greater degree than the minority recommendation.

9. Nevertheless, if the Government decided not to proceed with the broad extension of capital gains taxation, an extension of capital gains taxation to residential rental property and second homes would be an improvement over the current system. An extension to residential rental property only (i.e. excluding second homes) is not recommended as it would be likely to reduce the supply of rental housing.

Part B: Creating a Balanced Package

10. An evaluation of extending capital gains taxation should be made in the context of the complementary measures funded by the revenues raised by the extension. To the extent that there are concerns that raising taxes on capital could impede investment and productivity, a portion of the funds could be directed at balancing measures outside of taxing capital gains itself. Measures could include the business package or other measures of general application such as a reduction in the company tax rate. Concerns about increased compliance costs, especially for small businesses, could be similarly addressed by other measures as proposed in the report (Small Business Tax Measures IR2019/049, T2019/239).

11. Concerns can also be alleviated through design choices in the taxation of capital gains. Simplified rules can reduce compliance costs. Other measures can reduce the impact on desirable business rearrangements.

12. However, care must be taken that the measures do not undermine the achievement of the objectives of the extension. Exemptions can significantly impair the fairness and efficiency objectives; and can add considerably to the complexity of the tax system. In such circumstances, the result could be worse than the status quo. There could be a substantial increase in complexity with limited benefits in terms of fairness, efficiency and revenue gained.

Part C: The Main Building Blocks

13. This part outlines the main building blocks of broad capital gains taxation and seeks Ministers' direction on them. It is intended to allow Ministers to provide guidance to officials as they develop material for a more detailed discussion with Ministers later in the month. Ministers are also invited to indicate what further information they might need to make decisions. The issues raised in this part are summarised in the following table.

Part D: Timing of legislation and phased-in implementation

14. Officials have previously advised Ministers on options for the timing of legislation. Legislation for a broad extension of capital gains taxation introduced in Parliament before the 2020 General Election with effect from 1 April 2022 remains our preferred option. Legislation enacted before the 2020 General Election with effect from 1 April 2021 would be possible, but would carry increased risks of technical errors and complaints of inadequate consultation.

15. The Group's Report raised the possibility of a phased-in extension of capital gains taxation to provide additional time for development of the more complex aspects of the system. If a phased-in implementation were desired, the most feasible first phase would be an extension to residential real estate other than the family home,

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[1] As outlined in Joint Report – Tax Working Group – officials' initial advice on potential tax reforms for Budget 2019T2018/3429, IR 2018/800 a business package could include restoring depreciation on buildings, expanding black hole expense deductibility, and reducing restrictions on loss carry-forwards when a company is sold.

with a second phase extending capital gains taxation to all the remaining asset classes.

16. There has been some discussion with Ministers on the issue of timing. It is raised again to confirm views on timing and in case Ministers wish further discussion or information.

Recommendations

We recommend you:

1. **Note** the contents of this report

2. **Discuss** the issues raised in this report (summarised in the table below) with officials at the Joint Ministers' meeting scheduled for 12 February.

List of Issues for Discussion with Ministers
In relation to the following list of issues and proposals, Ministers are invited to provide (i) their current views; and, (ii) guidance on whether there is any particular additional advice that would be useful for decision-making.
Majority/minority recommendations The relative merits of the majority and minority recommendations.
Balanced packages Complementary measures to enhance productivity and reduce impacts on businesses (noting that additional advice will be provided by 22 February).
Tax rates Taxation at full marginal tax rates.
Realisation taxation Capital gains generally being taxed when realised.
Inflation adjustment Capital gains not being adjusted for inflation.
Partial extensions Partial extensions, other than possibly residential real estate.
Roll-overs Situations suitable for roll-over (noting that officials will provide further advice on roll-overs by 22 February).
Capital losses Capital losses generally being deductible against ordinary income, except in circumstances where there are integrity concerns.
Taxation of shareholders and their companies Taxation of shareholders and their companies (noting that officials will provide Ministers with further information by 22 February).
Effective date The taxation of capital gains applying to all assets, but only to gains and losses that accrue after the effective date of the tax.
Māori A specific engagement process with Māori about the impact of any extension of tax on capital gains for transactions relating to Māori collectively-owned assets.
Timing of legislation and phased-in implementation The following options for implementation. 1. Comprehensive tax, with legislation enacted before the 2020 General Election with effect from 1 April 2021; 2. Comprehensive tax bill introduced to Parliament before the 2020 General Election with effect from 1 April 2022; 3. A phased approach of residential property enacted before the 2020 General Election with effect from 1 April 2021 and the remaining asset classes introduced before the General Election in 2020 with effect from 2022.

Mark Vink
Manager
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ February /2019

Hon Stuart Nash
Minister of Revenue
/ February /2019

Design Issues in Extending the Taxation of Capital Gains

Purpose

17. This note covers four main areas:

- The majority and minority recommendations;
- Complementary packages;
- Design detail of capital gains taxation; and,
- Timing of legislation and phase-in

18. Ministers are asked to provide guidance in a number of areas that are critical to the design of capital gains taxation. This is not intended to prejudge whether capital gains taxation should proceed, but rather what form it would take if it were to do so.

19. Ministers are also invited to indicate what further information they would require and further options on which they would like information.

20. This report is the first of two on capital gains design. It includes questions on high-level design principles that officials would like to discuss with Ministers at the Joint Ministers' meeting scheduled for 12 February. Although it does not seek final decisions, the answers to these questions be helpful for the drafting of the subsequent report on the detailed design recommendations of the TWG report, scheduled to be delivered to Ministers on around 22 February.

21. On the understanding that Ministers wish to keep to the Government timeline of legislation enacted before the 2020 General Election, our advice is that a Government discussion document would need to be released not later than the end of May. Any later would mean an unreasonably short consultation period before final policy decisions were sought and turned into a bill for introduction.

22. Generally, discussion documents seek to consult on a relatively firm proposal based on Cabinet decisions. In saying this, there are always some areas where options are consulted on and Government will need to reassess the proposal following public feedback to ensure the design still achieves its policy objectives. Our report on 22 February meeting will provide recommendations on any areas of detail that could be 'left open' in the document.

23. To meet this May discussion document timeframe, and also allow the Government to meet its stated objective of making some form of public announcement in April, we consider that Ministerial decisions on these high-level design principles will need to be made not later than the Joint Ministers' meeting scheduled for 26 February, with decisions on detailed design having to follow in very early March. This would allow those decisions to be turned into a Cabinet paper for further coalition party discussions and Cabinet decisions in late March or early April. To this end, our 22 February meeting will also seek agreement to the design principles and details that will inform this Cabinet paper.

24. Any decisions on these high-level design principles that differ significantly from the design proposed by the TWG, or that are significantly delayed, will put pressure on the April announcement and May discussion document release. Any significant deviations from the TWG design may also cause officials to reassess our recommendations on the proposed reform.

Part A: Majority and Minority Recommendations

25. The Report provides both a majority recommendation supporting a general capital gains tax and a minority recommendation suggesting a tax on residential real estate only, with a potential extension to other assets in the longer run. The aim of this Part is to:

- Outline the majority and minority proposals
- Outline key pros and cons of the majority and minority proposals
- Discuss whether the minority proposal is better than the status quo

The majority and minority recommendations

26. The majority of the TWG (8 members) support a general broad tax on capital gains at full marginal rates on a very broad range of assets. This would include gains from all types of land and improvements (except for the family home), as well as gains from shares, intangible assets, and business assets but not personal use assets (such as cars, boats or other household durables). The aim is to make the tax broad; but most personal use assets are left out because they typically depreciate and as a simplification measure.

27. The minority argues for an 'incremental' approach. They argue that residential property (but not the family home) should be made taxable; but that the broader extension should not proceed. The minority is itself split between a recommendation that residential rental property plus second homes be taxable; and an alternative that only residential rental properties be subject to capital gains taxation.

28. Exactly what would be required for an asset to be added under the "incremental" approach to the set of assets where gains are taxed is not made clear. But it appears that the argument is that gains should be taxed when there are predictable expected gains on assets. Residential investment property is judged to be in that class because much less than a 3.5% return on net equity is being taxed. Many banks offer term deposit rates of around 3.5% and are relatively riskless. Given that rental property is a risky investment, equity investment in rental properties would normally be expected to be generating a higher rate of return.

Pros and cons of majority and minority recommendations

29. A number of reports have identified the key benefits of broad capital gains taxation as being:

- Improving the fairness and progressivity of the tax system. The tax increases horizontal equity by taxing different sources of income more equally; and increases progressivity because gains are earned predominantly by the rich;
- Increasing integrity and sustainability. It is difficult to protect integrity if there is a major gap between the company tax rate and the top personal rate without a capital gains tax and this gap is likely to increase over time;
- Increasing the neutrality of investment decisions; and,
- A source of revenue to finance complementary measures that promote Government priorities.

30. Key costs identified were:

- Higher taxes on savings and investment;
- Distortionary costs associated with taxing on a realisation basis especially lock-in and, depending upon options chosen, ringfencing of losses
- Complexity and administration and compliance costs.

31. If one believes that the advantages of a general capital gains tax outweigh the costs, this provides an obvious argument for taxing gains as broadly as possible which is the majority position. If, on the other hand, one thinks that the costs generally outweigh the benefits, this provides a reason for minimising harm by keeping the tax as narrow as possible.

32. The majority of the Group have made the judgement that the benefits of comprehensive taxation of capital gains out-weigh the costs. On the other hand, the minority judgement is the reverse; that the costs outweigh the benefits and so a broad extension of capital gains taxation is not warranted.

33. The minority position is consistent with taxing gains only where there is evidence of consistent gains taking place. It is important to understand the argument that can be advanced in favour of this position. There would be major distortions if there were no tax on assets where there are expected gains such as forestry. Taxing capital income on other assets but not gains on forestry would lead to overinvestment in forestry. But gains on forests are already taxed. The argument goes that we are already taxing gains in most areas where consistent gains can reasonably be anticipated. However, for assets which are neither expected to appreciate nor depreciate, this view would argue that taxing realised gains is very unattractive. It creates lock in and in many countries gains and losses are taxed asymmetrically which creates its own set of distortions.

34. The minority position follows this logic. It recommends taxing gains on residential rental property (and possibly second homes) because there is evidence of consistent appreciation and of income from this asset being undertaxed. (As noted above, considerably less than a 3.5% return on net equity is currently being taxed). But the minority position is that there should be a high burden of proof before adding assets to a schedule of assets where gains are taxed. Hence the suggestion is to stop there.

35. However, there is no evidence provided of whether anticipated capital gains are merely a residential property issue. Evidence from Corelogic for the period 1993 to 2017 shows evidence of consistent appreciation for many forms of land.

Average annual increase in median land value per hectare 1993-2017

Residential	8.4%
Commercial	6.2%
Industrial	7.1%
Dairying	7.1%
Pastoral	8.2%

36. There are also, of course, high profile instances where people have built up very valuable businesses which are later sold for a capital gain. If a major contributing factor is the talent and skills of the entrepreneurs who build up and sell the businesses, this will be another important area where expected capital gains are not taxed. There are well known instances where the entrepreneurs who sell these businesses note the unfairness of them not being taxed on the gains when much lower income people are taxed much more comprehensively on the income they earn.

37. The Minority conclude that in their view a comprehensive approach would impose efficiency, compliance and administrative costs that would not be outweighed by the increased revenue, fairness perceptions, and possible integrity benefits of the broader approach.

38. Reasonable people can come to different conclusions depending upon the relative weight they give to the Government's different objective. As noted elsewhere there are trade-offs among the objectives. Clearly, the minority position gives less weight to fairness and integrity and more to issues of impact on investment and complexity. But the differences underlying the minority thinking and officials' is deeper than that. There are significant differences in the qualitative understanding of the impact of capital gains taxation on each of the criteria.

39. These differences can be summarised as follows:

- **Fairness and Progressivity**– the minority refers to "fairness perceptions" suggesting that they think that it is perceptions of fairness rather than fairness itself which is the key issue. An important question for the Government is the importance it places on those with similar incomes paying similar amounts of tax and on taxing income in a progressive fashion so that those with greater ability to pay end up paying a greater proportion of their incomes in tax. A broad capital gains tax assists with both objectives.

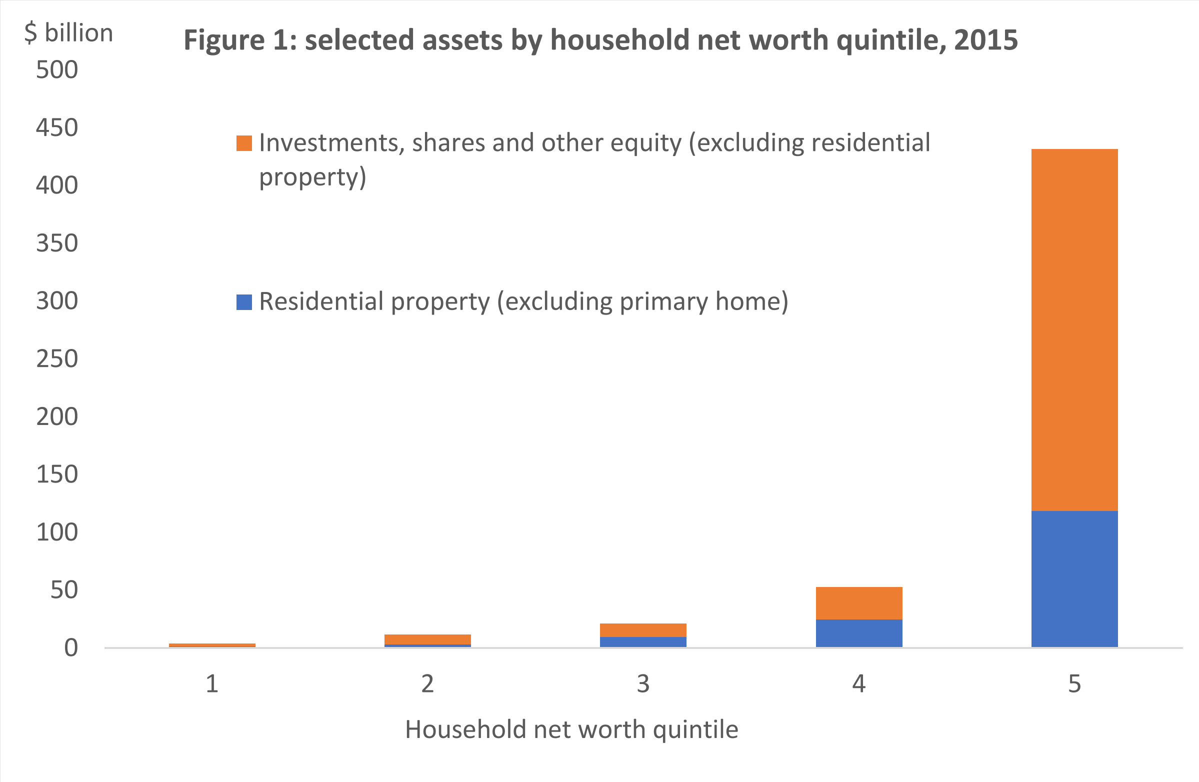
- **Integrity** – the minority refers to "possible integrity benefits". There is no discussion of what these benefits might be. A key goal of New Zealand's tax system is to tax income at progressive rates in ways which cannot easily be sidestepped. The non-taxation of capital gains undermines the integrity of the tax system. It makes it easier for labour income to be converted into untaxed capital gains, for companies to be used to shelter the income of high-income earners from higher rates of personal tax and for multinational firms to sell their IP offshore to facilitate lower payments of tax in New Zealand. Taxing capital gains directly helps address these issues.

- **Efficiency and Productivity** – the minority fears that capital gains taxation will damage entrepreneurship, experimentation and innovation and capital markets. While gains on domestic shares would be taxed, New Zealand's full imputation regime continues to provide a substantial incentive for people to invest in domestic equities. Capital gains on shares are taxed in the vast bulk of OECD countries and many have thriving share markets and entrepreneurship. Increased taxation of capital income can reduce investment. If potential productivity impacts are a concern to the Government, they have the option of using a portion of the revenues raised by capital gains taxation to productivity enhancing measures that would improve the efficiency of the tax system.

- **Complexity** – the minority is concerned that capital gains taxation will increase complexity. Provisions will be introduced where possible to minimise complexity, but inevitably there will be an increase. The minority report cites anecdotal evidence of increases in compliance costs of 30%. In contrast, studies of compliance costs of capital gains in Australia, measured compliance costs more in the order of 2% of total compliance costs. A package of compliance reducing initiatives in the general tax system targeted at small businesses has been proposed in the report Small business tax measures, IR2019/049, T2019/239.

40. The majority and minority recommendations differ in their impact on progressivity. There is limited data in New Zealand on the distribution of wealth and what assets the wealth is comprised of. The best information we have is from the *Household Economic Survey*. By making adjustments to that data to find the distribution of ownership of investments, shares and other equity (excluding residential investment property) (which would face no extension of taxation of capital gains

under the minority view) and residential rental property (which would), we can make judgments about the relative progressivity of each option[2].



41. As one might expect and as can be seen in Figure 1, most investments, shares and other equity (excluding residential investment property) (86%) and residential investment property (75%) are held by the wealthiest quintile of households.

42. However, investments, shares and other equity (excluding residential investment property) make up 41.1% of the wealthiest quintile's assets, while residential investment property only makes up 15.6% of this quintile's assets. Some investments, shares and other equity (excluding residential investment property) will be bonds and debt securities that are already comprehensively taxed, but much of the wealth will be shares in businesses and other investment funds. As a result, not only are most of the investments, shares and other equity (excluding residential investment property) that would be exempt held by the wealthiest quintile, but this quintile's portfolio is much more skewed toward these assets than investment property. Accordingly, the minority recommendation would increase progressivity to a lesser extent than would comprehensive capital gains taxation.

43. Key advantages and disadvantages of the minority recommendation relative to comprehensive capital gains taxation are summarised in the following table.

[2] Residential rental property includes residential rental property equity in trusts, investment property equity in unlisted and unincorporated businesses. Due to data limitations the investment property equity in unlisted and unincorporated businesses will also include non-residential property held in private businesses. As a sensitivity analysis we have looked at the results when this item is excluded, and it does not materially change the results. Financial assets include pension funds, bonds and other debt securities, equity in own unincorporated enterprises, shares and other equity, mutual funds and other investment funds, life insurance funds and annuities, and other household financial assets

Estimates are approximations based on survey sample data and therefore subject to uncertainty. Total estimated assets in the Household Economic Survey do not exactly match estimates from aggregate data, likely owing from survey under-coverage of high-wealth households and/or under-reporting of assets in survey responses

Comparison of the Majority and Minority Recommendations

Objective	Broad base	Residential rental or residential rental plus second homes only
Revenue over 5 years	$8.3 billion	$2.8 billion[3]
Impact on packages	• Provides significant funds for balancing initiatives in package; • Could fund productivity measures and/or fairness measures • $4.0 to $5.3 billion for fairness measures after Business package.	• Less need for business package (although business package desirable on own account) • Funds could be directed at fairness measures
Progressivity	• Substantial increase in progressivity • Financial assets concentrated in upper income percentiles • Taxing financial and business assets targets increased taxation to upper income earners	• Smaller progressivity benefit • Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed
Horizontal equity	• Greater improvement • More closely aligns capital income taxation to taxation of other income	• Modest improvement • Evens out taxation of residential real estate with fully-taxed assets • At the same time means harsher treatment for residential real estate than most other appreciating assets. • Under-taxation of capital gains on business and share assets remain
Efficiency and Productivity	• Capital gains taxation raises tax on capital income reducing incentive to invest and productivity • By itself, likely to reduce efficiency and productivity although net effect with business package could be productivity enhancing • Evens out taxation across activities with different percentage of capital gains • Lock-in effect	• Like land tax, relatively efficient (non-distorting) source of revenue • Evens out taxation of rental residential real estate with fully-taxed assets • Under-taxation of capital gains on business and share assets remain • Lock-in effect on taxed assets

[3] Of which about $0.4 billion comes from taxing second homes. This revenue estimate is preliminary and indicative and may change following receiving further information or quality assurance. The costing is in tax years and will be different once converted into fiscal years.

Sustainability	• Broadening tax base and removing untaxed income improves sustainability of tax base. • More robust if divergence between company and personal tax rates	• Broadens revenue base • Does not respond to divergence in tax rates
Integrity	• Reduces scope for companies to be used to shelter income from higher rates of personal tax • Stops conversion of income into capital gains • Reinforces fairness and sustainability gains	• No effect on integrity outside of labour component of rental residential housing appreciation • Need for rules for land-rich companies
Complexity	• Increases compliance costs for all taxpayers earning capital gains • Valuations of existing assets when tax comes into effect complex especially for business assets and private shares • Complex adjustment for shares of members of corporate groups	• Much smaller increase in compliance costs • Increases compliance costs for landlords or landlords plus those with second homes. • Valuations of existing assets less complex than other business assets and private shares
Coherence	• More coherent due to more comprehensive definition of income	• Leaves fundamental incoherence of exempting a portion of income
Housing affordability	• Some small increase in rents and some fall in price of houses may occur	• If it applies only to rental property likely negative. Taxing gains on residential rental, but not second homes, will tend to reduce housing supply. • If also applies to second homes, some small increase in rents and some fall in price houses may occur

Is the minority position better than the status quo?

44. Extending taxation to capital gains to residential property makes progress towards most of the Government's objectives, provided that second homes are included in the tax base. If second homes are not included there is the risk that taxpayers anticipating capital gains would remove houses from the rental market, leaving them vacant and reducing housing supply.

45. Gains on residential rental property and second homes are an important source of untaxed income. Around one third of capital gains are expected to be on residential rental property and second homes. Gains on this would become subject to tax. It would remove the bright-line test for residential investment property. (This is a relatively unattractive tax because it can be sidestepped by holding such property beyond 5 years).

46. While some new distortions would arise, e.g., between residential property and other property, it seems doubtful that associated distortions would have very large efficiency costs. There tend to be relatively low deadweight losses associated with

taxes on land. It seems likely that this tax would have a lower efficiency cost than many other taxes yielding comparable revenues.

Part B: Creating a balanced package

47. Concerns have been raised that taxing capital gains could reduce productivity and inhibit certain business development, particularly for small businesses. As noted, increasing taxation of capital income would likely impair productivity, on its own. However, the assessment of the impact of broad capital gains taxation on the objectives of the Government depends critically on how the funds raised by the extension are used as part of the complementary package of changes and on the detailed design of the tax.

48. There are inevitable trade-offs between the objectives. For example, taxing capital gains increases progressivity, improves horizontal equity, and contributes to the integrity of the tax system. But it has effects on efficiency and productivity which go in different directions. On one hand it improves efficiency and productivity by evening out rates of tax across sectors, improving the allocation of investment. On the other hand, lock-in will reduce capital mobility and there is an increase in taxation of income from capital that, this will reduce the total amount of investment. On balance we expect that there would a net loss in productivity. However, this judgement does not take into account the use of the funds raised. If sufficient portion of the funds are used in ways that enhance productivity, the Government can achieve significant fairness gains without impairing overall productivity. Finally, compliance costs will increase.

49. Complementary measures that address productivity and compliance concerns could include:

- The package of business measures previously provided that were identified by the Group;
- A package of small business compliance measures outlined in the report Small business tax measures, IR2019/049, T2019/239; or,
- Other general measures to support productivity such as a reduction of the company tax rate.

50. In addition, there are detailed design choices that can mitigate negative effects on business activity and compliance costs. These include generally allowing capital losses to be deducted against ordinary income; allowing roll-overs in appropriate circumstances; and developing simplified methods of compliance where possible.

51. On the other hand, there are other possible provisions, such as exemptions, that could undermine the effectiveness of capital gain taxation in achieving its fairness and integrity objectives. Introducing a capital gains tax with substantial holes in the base could incur significant extra compliance costs while failing to meet the Government's goals for fairness, integrity and efficiency, and while raising less revenue for complementary measures.

52. In the opinion of officials, there are considerable advantages of using a combination of careful design of broad capital gains taxation plus introducing complementary measures in the general tax system, rather than compromising the design of capital gains taxation.

Part C: The main building blocks

53. This Part outlines the major design choices facing the Government in implementing broad capital gains taxation. In assessing the impact of capital gains taxation, the

devil is in the details. How taxing capital gains would affect taxpayers depends critically on detailed design decisions of policy-makers. The challenge is to design provisions, as part of a consultative process, that can be complied with and do not unduly interfere with business decisions; without compromising the Government's goals of fairness, efficiency and integrity of the tax system.

54. Careful design can help the Government make the necessary trade-offs among its objectives. At the same time, design decisions can mitigate the compliance costs and potential negative effects of raising taxes on capital.

55. The following provides background on the main structural issues for background purposes and asks Ministers for direction in a number of critical areas.

56. Capital gains taxation has been successfully implemented in most OECD countries. New Zealand can learn from other countries' experiences. A critical goal of consultation will be to respond to the legitimate concerns of taxpayers in crafting rules that simplify the application of the tax and ensure that unintended anomalies do not occur.

57. Some commentators suggest that the Group recommendations for capital gains taxation would be unduly harsh, complex or unfair compared with capital gains taxation in other countries. The recommendations of the Group fall within the range of provisions adopted in other countries. The general characteristics of capital gains taxation are common across countries; and the Group recommendations are, for the most part, standard practice. At the level of detail, countries are more or less stringent in different areas. This is also true of the Group's recommendations. The rules are more stringent than most in some areas but there are other countries with more stringent rules. In other areas the rules are less stringent than in many countries. This reflects the common sense, practical approach adopted by the Group and supported by officials.

Taxation at full marginal tax rates

Group recommendation

58. The Group has recommended that capital gains be combined with other income and be taxed at full marginal tax rates.

Comments

59. Relative to the majority recommendation, partial taxation of capital gains would have significant disadvantages. It would:

- Provide less revenue to fund Government priorities as part of a complementary package of initiatives;
- Be less progressive, leaving higher income taxpayers earning capital gains facing lower tax rates than other taxpayers;
- Be less horizontally equitable as taxpayers with similar incomes, but with and without capital gains, would pay different amounts of tax;
- Be more complex as it would retain the differential in taxation between income and capital gains:
- Be less effective in evening out investment incentives across assets; and,
- Be less effective in improving the integrity of the tax system as there would still be incentives to convert ordinary income to capital gains.

60. The complexity issue is worth emphasis. One of the perennially difficult administrative borderlines that leads to contention between administrators and taxpayers is the distinction between income and capital gains. Taxing capital gains at full rates and allowing capital losses to offset other income reduces the circumstances where it is necessary to distinguish between income and capital gains. This is a major operational simplification for taxpayers and tax administrators.

61. There would be benefits from a lower tax rate, including:

- Less taxation of certain types of capital, reducing negative effects on productivity;
- Lock-in would be reduced, promoting greater flexibility in allocating capital; (however allowing roll-overs can mitigate some lock-in issues, for example with corporate reorganisations); and,
- Reduced distortions arising from asymmetric treatment of gains and losses; (however, allowing losses to be offset against ordinary income addresses this issue directly).

62. Some other OECD countries tax capital gains at lower tax rates than other income or with a partial income inclusion. This raises the concern that New Zealand could be treating capital gains more harshly than some other jurisdictions. This must be seen in context. Other countries have higher top marginal tax rates, so that the net difference in tax rates on capital gains is smaller than would otherwise occur. For capital gains earned in companies and distributed to individuals, New Zealand would be at the low end of effective tax rates due to imputation which relieves double taxation of income earned through companies. For capital gains earned directly by individuals, New Zealand would be at the higher end of effective tax rates, but a significant number of countries would have effective rates in the range of 25% to 30%[4], and some countries such as Germany, Italy, Ireland and Denmark apply tax rates of 33% or more. To the extent that this is a disadvantage, New Zealand's proposed relatively generous loss offset rules would provide an important counter-weight.

63. The rate of tax to be applied to capital gains is a fundamental building-block of capital gains taxation. Partial inclusion of capital gains or taxing at a lower tax rate implies radically different legislation design, administration and compliance. The problem is the need to separate out costs and revenues in a separate computation of capital gains rather than integrating it in the general calculation of income.

Officials' position

64. Officials believe with a top marginal tax rate of only 33% it is reasonable to tax capital gains at full rates. At higher tax rates, concerns about lock-in and any asymmetry in taxation of gains and losses could make a lower tax rate desirable.

Realisation taxation

Group recommendation

65. The Group recommended that capital gains would be taxed generally when there is a change of ownership or sale of the asset or when the asset is deemed to be sold.

[4] Harding, M. and M. Marten (2018), "Statutory tax rates on dividends, interest and capital gains: The debt equity bias at the personal level", OECD Taxation Working Papers, No. 34, OECD Publishing, Paris.

Rollovers (discussed in next section) should be available in certain circumstances that would otherwise be a realisation event.

Comments

66. All countries that tax capital gains do so on a realisation basis. The theoretically pure option of taxing gains on accrual is rejected due to the complexity of annual valuation of assets, and the unavailability of cash to pay the tax on illiquid assets.

67. Realisation taxation raises issues. It defers taxation of capital gains relative to income on assets whose income is taxed annually meaning that the effective tax rate on capital gains remains below that for income on other assets. (The table shows the extra accumulated value of a capital asset of 100 earning a five percent return that is taxed at realisation, as compared to the accumulated value of an asset such as a bond that is taxed as the income is earned.)

Accumulated Value of an Investment of $100 (years 1 to 40)							
	1	5	10	15	20	30	40
Accrual Taxation	103	118	139	164	193	269	374
Realisation taxation	103	119	142	172	211	323	505
Realisation/accrual	100%	101%	102%	105%	109%	120%	135%

68. Taxpayers may have the option of when to sell assets allowing them to advance losses while deferring income. Rules may be needed to prevent artificial losses due to churning or self-dealing. Finally, realisation taxation (a tax benefit to investors) leads to the problem of lock-in, where tax payers can reduce taxation by holding on to assets they would otherwise sell in the absence of taxation.

Officials' position

69. Officials agree that capital gains should be taxed as realised and that deemed realisations should be made when there is a change of use or a migration.

Adjustment for inflation

Group recommendation

70. The Group recommended that capital gains not be adjusted for inflation.

Comment

71. Taxation of nominal gains means that the inflationary component of income is taxed for all types of capital income. In theory capital income should be adjusted for inflation. Countries have examined introducing inflation adjustments on numerous occasions, but, with a few exceptions of high inflation economies, have opted to continue to tax nominal income. Inflation adjusting only certain types of income would be highly distortionary and subject to tax planning.

72. Among categories of capital income, capital gains is <u>least</u> affected by inflation since the deferral of taxation due to realisation taxation avoids the compounding effect of annual taxation of income that applies to income such as interest.

73. The following table shows the effect of inflation on taxation of capital income on a bond, which is fully taxed as income accrues and an asset earning a capital gain which is only taxed at the end of the period. The table compares the after-tax value of the investment compared to the after-tax value of the investment had the tax base been inflation adjusted. Assuming a 5% nominal return and an inflation rate of 2%, the after-tax value of the fully taxed investment falls further behind the inflation adjusted asset over time. But the capital gains asset does not fall as far and after enough time the after-tax return actually exceeds the return on the inflation adjusted asset. The benefit of deferred realisation taxation exceeds the benefit of inflation adjustment.

Accumulated Value of $100 Investment (years 1 to 40)							
	1	5	10	15	20	30	40
Indexed	104	122	148	180	220	325	482
Full accrual	103	118	139	164	193	269	374
Full realisation	103	119	142	172	211	323	505
Full accrual/indexed	99%	97%	94%	91%	88%	83%	78%
Full realisation/indexed	99%	97%	96%	96%	96%	99%	105%

Officials' position

74. Officials agree that capital gains should not be adjusted for inflation

What is taxed

Group recommendation

75. The majority of the Group has recommended a broad extension of capital gains taxation applying to most assets. The system would include gains from all types of land and improvements (other than the family home), shares, intangible assets and business assets. The principal exclusions are assets acquired for personal purposes, other than secondary residences. Gains on other financial assets, such as bonds, are already taxed under the Financial Arrangements rules; and most overseas equity investments are taxed under the FIF rules.

Comments

76. The intention of the recommendation is broad taxation of assets expected to give rise to capital gains. Assets were specifically listed to avoid problems of unintended application of the tax

77. Most personal assets would be outside the tax base. The only category of personal assets to be subject to tax on their capital gains would be real estate other than the family home. Taxed assets would include second homes. Real estate assets can give rise to substantial capital gains, in large part due to increases in the price of land.

78. Personal-use assets, such as cars, tend to depreciate with use and so would not be expected to give rise to capital gains. Losses on the other hand would be assumed to result from depreciation resulting from the use of the assets, a form of

consumption, and should not be deductible. Accordingly, these assets would not be subject to capital gains taxation. Potential exceptions to this could be art, jewellery and some collectibles, which can generate significant capital gains. Traders in such assets would be taxable under ordinary income tax concepts.

79. An extension of taxation to personal assets where gains might be expected, perhaps over a threshold, was considered, but was not recommended by the Group. While a number of countries tax personal-use assets, officials concur that such taxation is unlikely to be worth the additional compliance burden. This is an example of an area where New Zealand would be less stringent than some other countries.

80. The Report summary and covering letter suggests that there are partial extensions of capital gains taxation to some assets but not others that could be considered. Partial extensions, other than the minority recommendation are not discussed in the body of the Report. The Report does not offer suggestions of what these might be.

81. The minority recommendation would extend capital gains taxation only to rental residential properties (possibly including second homes). While this option appears technically feasible, it would provide significantly fewer funds to pursue Government priorities and would substantially fail to address fairness and integrity concerns. The minority report is discussed in greater detail in Part A.

82. Partial extensions (other than to residential property) would generally raise significant implementation issues and can treat similar taxpayers differently depending upon which assets they hold.

83. Potential partial implementations could be:

- **Residential property**, (residential rental property plus second homes if desired), is less mingled with other assets than other business assets. To the extent that there is separation, then problems of separate valuation and streaming costs and revenues would be minimised.

- **Targeting specific business assets** including land and real estate would be more problematic technically and have increased compliance costs. Most of the rules needed for general taxation would be required. Moreover, they would be very problematic from an implementation point of view. There would likely be complex borderlines to police. Valuations would require taxpayers to disentangle the value of taxable from non-taxable assets in a business when the business is sold. Expenses would need to be allocated between taxable and non-taxable activities. Taxpayers with equivalent economic situations could find that they had different tax outcomes depending upon how their affairs were organised. This could cause distortions in investment patterns and business organisation.

- **Private company shares** raise complex technical issues that would need to be resolved. Moreover, it is difficult to tax the shares effectively without taxing business assets at the same time, at which point partial extension would make little sense.

84. Effective delivery of partial extensions other than residential real estate raises significant problems. The problems would become more salient if the full extension of capital gains taxation was delayed or abandoned.

Officials' position

85. Officials concur with the recommendation that there be a broad extension of capital gains taxation.

86. Officials did not have an opportunity to fully analyse or report on partial extensions to the Group.

87. Exempting categories of income earning assets would generally fail to achieve the objectives of the Government and, if extended beyond residential property, might not be possible to implement in a reasonable timeframe.

Roll-overs

Group recommendation

88. The Group proposed that roll-overs of capital gains taxation be provided for certain life events such as death and separation and for certain Maori collectively-owned assets. They have also proposed roll-overs for a number of business situations, such as involuntary realisation events where the funds are reinvested in a similar asset, certain business restructuring, and reinvested funds of small businesses.

Comments

89. Roll-overs allow a deferral of the taxation of capital gains when certain realisation events occur. The taxation of capital gains is deferred, the cost base of the asset is maintained, and taxation only occurs when a subsequent realisation event occurs that does not qualify for a roll-over.

90. Roll-overs can soften the impact of capital gains taxation, preventing taxes from inhibiting desirable business re-arrangements or in circumstances where taxation might impose an undue hardship. Roll-over provisions vary enormously across countries. Used judiciously they can smooth out the operation of the tax system. On the other hand, if used indiscriminately, roll-overs can undermine the effectiveness of capital gains taxation in achieving its goals of fairness and efficiency; and can increase complexity as the rules need to be targeted and complied with.

91. Different roll-overs respond to different policy concerns, including:

- Involuntary realisation events beyond the taxpayer’s control; such as expropriation, or an asset that is destroyed, provided that the disposal proceeds received are reinvested in a replacement asset;
- Business reorganisations with the same ownership maintained, such as the incorporation of a sole proprietorship. In this case, there has been a change of ownership in form, but not in substance;
- Relationship property transfers between spouses or as part of a relationship property settlement.

92. However, roll-overs can increase lock-in as capital gains accumulate untaxed. The provision of roll-overs without strict criteria can be a precedent for further requests that can undermine fairness if they allow taxation of significant accumulations to have taxes to be deferred.

93. Allowing extensive roll-overs in combination with generous loss offset provisions (see next section) could open up the possibility of timing mismatches between losses and income.

Officials position

94. Officials generally agree that there should be some life event roll-overs and a reasonably limited set of business rollovers, addressing involuntary realisation events and business reorganisations. Care must be taken beyond that as roll-overs can frustrate attaining the objectives of capital gains taxation. At the same time, roll-overs can mitigate some of the negative effects on business operations.

Capital Losses

Group recommendation

95. In general, the Group recommends that capital losses be deductible against other income. However, there are a number of circumstances where losses should be restricted, or other measures introduced to protect the integrity of the tax system.

Comments

96. In most OECD countries[5], capital losses can only be deducted against capital gains. This is intended to prevent taxpayers from using capital losses to shelter other income from tax while deferring taxation of capital gains on assets that have increased value. Such countries also tend to tax capital gains at different rates than ordinary income. However, some countries only ring-fence losses on shares[6] and there are targeted reliefs in other cases. The Group has proposed that most types of capital losses can be deducted without restriction. The proposed New Zealand treatment of losses would be among the most liberal among OECD countries.

97. It is important to note that the New Zealand Venture Capital Association (NZVCA) supported capital gains taxation because it would allow deductions for capital losses in start-ups.

98. Allowing losses to be deducted would have beneficial effects in the taxation of risk. A particular problem with loss restrictions is that they treat gains and losses asymmetrically. The government shares in gains through taxation; but does not share fully in losses if they are restricted. This asymmetry creates a bias against risk by discouraging risky but potentially high-return investments. The bias against risk can be eliminated by removing the restriction. Some extra volatility in Government tax revenue over the business cycle will occur as a result.

99. Nevertheless, as noted by the Group, there will be situations where some form of restriction may be appropriate. These situations result from realisation taxation and the ability of taxpayers to choose when to cause a realisation event for an asset with an accrued loss. Problems can occur for liquid assets where losers can be sold while gainers held; or when there has not been a real third-party sale of the asset. Accordingly, the Group recommended that losses from portfolio-listed shares be ring-fenced.

100. There are other types of transactions where a loss restriction is appropriate. For example, an asset with an accrued loss can be sold to a related party; or an asset with a loss can be sold, and then an identical replacement asset immediately repurchased. In both cases there has not been a real change in the ownership of assets, but a loss has been triggered. Fairly standard provisions exist in other countries to deal with these problems.

[5] Norway and Switzerland do not.
[6] Japan and Mexico

Officials' position

101. Officials agree that capital losses should be deductible against ordinary income as a general principle, (although some exceptions are necessary, such as portfolio shares and other liquid assets). Officials are examining whether to recommend a further extension, compared to the Report, of the types of losses that would be deductible against ordinary income. For example, the Group has recommended that losses on assets valued on Valuation day be restricted due to problems in valuation.

102. Officials are also examining other situations where some form of loss restriction may be appropriate.

Taxation of shareholders and their companies

Group recommendation

103. The Group noted that the combination of taxation of income in a company and capital gains on sales of shares at the shareholder level can lead to the possibility of double taxation or double losses in some circumstances. Some technical responses were suggested.

Comments

104. Many of the most contentious issues in developing provisions for the taxation of capital gains, other than taxing capital gains at all, involve issues of taxing shareholders and their companies. New Zealand has an advantage over most other countries in this area due to the imputation system and its reasonably close alignment of company and personal tax rates. Arguably, taxing capital gains completes the existing system, providing a better balance, and improving fairness and integrity.

105. The Report raised the issue that double taxation and losses, once in the company and again at the shareholder level, can occur when capital gains are taxed. Issues of double taxation and deductions are nothing new. All countries' tax systems, including New Zealand's current system, have issues in this area.

106. There are a variety of inconsistencies in the level and timing of taxation due to the separate taxation of shareholders and their companies. These inconsistencies are the basis of many of the tax planning problems that undermine the integrity of the current tax system. For example, in the absence of capital gains taxation, sales of shares instead of paying dividends allows taxpayers to defer, and in some cases eliminate, taxation by using dividend avoidance schemes.

107. New Zealand's imputation system, which ensures that personal tax rates are paid on distributed income earned through companies, puts New Zealand in a better place with respect to these issues than other countries.

108. Capital gains taxation further improves the system as it eliminates some of the inconsistencies which provide opportunities for tax avoidance and improves the taxation of accruing but unrealised gains. Arguably it brings a better balance into the tax system.

109. Because of imputation, New Zealand companies face fewer problems of double taxation. New Zealand public companies have higher than average pay-out ratios of retained earnings. Private company taxpayers can use simple self-help measures to avoid problems; for example, by paying taxable bonus issues to avoid double taxation of retained earnings.

110. In some cases, self-help may not be available. In those cases, over-taxation could occur. Otherwise desirable economic transactions might be inhibited. In other cases, double losses may arise. Where these situations occur, provisions may be necessary that alleviate the problem.

111. For example, as suggested by the Group, the continuity rules for imputation credits and losses should be re-examined in the context of capital gains taxation. Officials are examining this area. Care would be needed to ensure that relaxation did not open up opportunities for trading in unused credits and losses. Risks may be exacerbated when groups of companies are involved

112. Capital gains taxation changes the nature of the issues in this area; and justifies an examination of consequential measures to reduce unintended effects, even as it fixes other issues with the current system.

113. Finally, applying capital gains taxation within corporate groups raises complex issues, involving the possibility of either over- or under-taxation. It will be necessary to have careful consultation to develop the necessary legislation.

Officials' position

114. The introduction of capital gains taxation of shares addresses serious integrity issues that arise currently around share-holder and company taxation. Officials agree that the taxation of capital gains changes the issues in this area and that some adjustments to current rules, such as the continuity rules, may be warranted. They are examining other possible amendments to mitigate unintended effects of introducing capital gains taxation. This will be an important area for consultation.

Effective date (valuation day)

Group recommendation

115. Taxation of capital gains would apply to all assets, but only to gains and losses that accrue after the implementation of the tax.

Comment

116. Only taxing gains and losses that have accrued after the effective date avoids retroactive taxation. However, it requires a valuation for all existing assets to determine the gains that have accrued after implementation.

117. A valuation day avoids the investment biases that occur with alternatives such as grand-parenting assets. (That is, taxation only applies to assets purchased after the implementation of the tax.) Moreover, the recommended approach produces substantially more revenue over the first five years and avoids complexities necessary to ensure that assets which change over time are deemed to enter the tax base. Australian experts have also advised that the grandparenting approach (which was used in Australia) introduces a significant amount of complexity and imposes compliance costs as an entirely different set of rules is required to deal with grand-parented assets compared to other assets.

118. The major concern with a valuation day is the complexity of establishing the values on the day. For some assets, such as public shares, valuation can be taken directly from publicly available data sources. For others, such as property, publicly available data can be used as a basis for valuations. But others, such as private businesses can have unique characteristics that require more complex valuations. This is a complicated process. Various optional approximations are being examined to reduce compliance costs for hard to value assets.

Officials' position

119. Officials agree with a valuation day approach and are examining ways to minimise compliance costs.

Māori taxation issues

Group recommendation

120. The Group has noted in several places that the treatment of assets in collective Māori ownership (such as Māori Freehold Land and assets held by post-settlement governance entities) warrant special consideration under any extension to the taxation of capital gains. In some cases, the Group has recommended consideration of an exemption (for example, the disposal of Māori Freehold Land or interest in that land), and in others the Group has recommended consideration of rollover relief. In all cases, the Group suggests that solutions be developed through further engagement with Māori under the GTPP "to ensure the rules achieve the intended policy".

Comments

121. Treatment of transactions related to assets in collective Māori ownership will need careful consideration in the context of extended capital gains taxation in light of ongoing impact of historical Crown actions relating to these assets and the impact of legislation, such as Te Ture Whenua Māori Act, on how they are managed and the circumstances around sales. Options should be considered from a tax policy perspective and also with Crown-Māori relationship objectives and principles in mind, including any potential compounding effects across the Government's current policy programme.

122. Participants in last year's process indicated that they would like further engagement as the policy work progresses and key design features have been determined. Getting as clear as possible about potential impacts will enable well-informed advice to Ministers on likely issues and options and timely decision-making. Officials are working with Crown Law so that we can continue to advise whether the approach is consistent with the Crown's obligations under the Treaty of Waitangi to act in good faith.

123. Any engagement will need to allow for the detailed development of specific treatment options to meet the Government's timeline for implementing the tax change, while genuinely considering other approaches to ensure it is a good faith process.

Officials' position

124. We would recommend further engagement with Māori on any extension of taxing capital gains to ensure that the potential impacts for collectively-owned assets and entities are understood, and any unintended effects can be anticipated and addressed, as appropriate.

125. Officials will provide more specific advice about how an engagement process achieve these objectives and, if this is agreed, will provide updates at each stage of the process about any implications for the timeframe for the tax change and, if necessary, how any alternative approach they might be addressed through the policy and legislative process.

Part D: Timing of legislation and phased-in implementation

Group recommendation

126. The Report did not analyse or make recommendations on a phased-in implementation. The letter from Sir Michael to Ministers indicated that the "Government also has options around how to stage the timing of introduction and whether to phase in the inclusion of asset classes." The TWG report itself also notes that the Government "has options about how to stage the timing of introduction." [7]

Comments

127. Phased-in implementation has been suggested to address concerns about achieving a successful implementation within compressed timelines. As alluded to in our report dated 1 February (T2019/113 / IR2019/041 refers), on the assumption that a comprehensive tax is preferred, officials consider there are three main implementation timing options:

- *Option 1* - Comprehensive tax on the Government's proposed timeline of legislation enacted before the 2020 General Election with effect from 1 April 2021;
- *Option 2* - Comprehensive tax bill introduced in Parliament before the 2020 General Election with effect from 1 April 2022;
- *Option 3* - A phased approach, with residential property (other than the family home) enacted before the 2020 General Election with effect from 1 April 2021 and the remaining asset classes introduced before the General Election in 2020 with effect from 1 April 2022. This split between residential property and the rest, rather than any other dividing line, is for the reasons noted in the "what is taxed" section of this report.

Officials' position

128. Officials have previously advised that our preference is for Option 2, which would allow for consultation both on the design detail and possibly some key aspects of legislative drafting before any amendment bill was considered by Select Committee.

129. We have also previously advised that we could meet the timelines for Option 1 if necessary. Both these pieces of advice still stand.

130. In saying this, we reiterate that Option 1 significantly increases the risk of:

- Technical errors in the legislation that will require remedial amendment; and
- Complaints from stakeholders that any consultation process is inadequate for what will be an important and complex set of legislative amendments.

131. Legislation that requires substantial amendment post-enactment increases uncertainty and can impose significant compliance costs on taxpayers, who may have to update their processes in response to changes in the way that the tax operates. The TWG also noted that this timeline was "challenging".

132. If Ministers are considering a phased approach, officials consider that Option 3 has the following advantages when compared with Option 1:

[7] Tax Working Group Final Report, Volume I, paragraph 13.

- There is clearly significant stakeholder concern over the details of any proposals. Extra time would allow a more thorough consultation process, improving the overall quality of the bill at introduction and easing these stakeholder concerns. Shorter timeframes also put more pressure on the process to understand impacts for Māori collectively-owned assets and associated decisions by the Government, which is necessary to ensure that the Crown has acted in good faith in relation to its Treaty partner;

- The boundary between residential property and the rest is relatively neat, which would make extending income tax to that class of assets relatively simple and also minimise the need for temporary measures;

- Having a delay of only one year would lessen the pressure on temporary measures anyway because it limits the benefits of taxpayers structuring to avoid the tax;

- Introducing a comprehensive bill to Parliament before the 2020 General Election would, in our view, meet the Government's objective of providing certainty to taxpayers on the design of the tax;

- Although it would generate less revenue in earlier years than Option 1, it would still tax a large asset class in 2021-22 year and therefore generate more revenue that Option 2.

Inland Revenue
Te Tari Taake
POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Further information on potential distributional impacts of extending the taxation of capital gains

Date:	11 February 2019	**Report No:**	T2019/242 IR2019/068
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report	None
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Mark Vink	Manager, Tax Strategy	s9(2)(a)	N/A	
Phil Whittington	Senior Policy Advisor, Inland Revenue		s9(2)(a)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes - 3 Distributional analysis and incidence (Treasury:3993062v1)
c Distributional analysis (Treasury:3947407v1)

Tax Policy Report: Joint Report: Further information on potential distributional impacts of extending the taxation of capital gains

Executive Summary

This report responds to a request from Ministers for further information on the potential distributional impacts of extending the taxation of capital gains, including on the number of individuals that could be directly affected.

Specific data relating to capital gains in New Zealand is highly limited. Therefore, all of the impact analysis in this report necessarily relies on approximations and assumptions. Accordingly, all the results should be considered as indicative only.

The information in this paper summarises previous information provided to the Tax Working Group in the Secretariat papers on *Distributional analysis* and *Distributional analysis and incidence*. These are attached. This report also provides new analysis including:

- Further breakdowns of the estimated impact of taxing capital gains across net worth deciles (Figures 5-7)
- The proportion of residential assets held by each household net worth decile compared with non-residential assets potentially subject to an extended taxation of capital gains (Figure 8)

Some of this new analysis has been prepared relatively quickly and should be considered preliminary.

The key results from the analysis are:

- A broad-based extension of the taxation of capital gains (as recommended by the majority of the Tax Working Group) would be progressive. In particular, the additional tax would be paid mostly by those with high wealth.
- An extension of the taxation of capital gains applying solely to residential investment property (as recommended by a minority of the Tax Working Group) is also likely to be progressive. However, it is likely to be less progressive than a broad-based extension of the taxation of capital gains.
- Taxing capital gains is likely to have an uneven impact across industries. For small and medium enterprises, most tax from capital gains are expected to be paid by the property, agricultural and finance sector.

We intend to discuss this report further with your office to determine whether there is further information we can provide that could assist you in decision-making, including in relation to distributional analysis of potential packages for Budget 2019. We will also be available to discuss further with you, if required, at our meeting scheduled for 13 February 2019 on the Government's response to the Tax Working Group.

Recommended Action

We recommend that you

(a) **note** the contents of this report

Noted *Noted*

(b) **discuss** this report with officials, if required, at the meeting scheduled for 13 February 2019.

Mark Vink
Manager, Tax Strategy

Phil Whittington
Senior Policy Advisor, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Purpose of Report

1. This report responds to a request from Ministers for further information on the number of individuals who would be likely to pay tax on capital gains and on the distributional impact of taxing capital gains. The Minister of Revenue requested other information from officials which we have provided in a separate report (IR2019/031, T2018/175 refer).

2. The distributional analysis is based on the proposed design of an extension of the taxation of capital gains by the majority of the Tax Working Group. We will update the analysis following design decisions by the Government.

3. The information in this paper summarises previous information provided to the Tax Working Group in the Secretariat papers on *Distributional analysis* and *Distributional analysis and incidence*. These are attached. This report also provides new analysis including:

    - Further breakdowns of the estimated impact of taxing capital gains across net worth deciles (Figures 5-7)

    - The proportion of residential assets held by each household net worth decile compared with non-residential assets potentially subject to an extended taxation of capital gains (Figure 8)

4. Some of this new analysis has been prepared relatively quickly and should be considered preliminary. In addition, there is limited data in New Zealand on the distribution of wealth and what assets the wealth is comprised. Many of the estimates are approximations based on survey sample data and therefore subject to significant uncertainty[1].

5. We intend to discuss this report further with your office to determine whether there is further information we can provide that could assist you in decision-making, including in relation to distributional analysis of potential packages for Budget 2019. We will also be available to discuss further with you, if required at our meeting scheduled for 13 February 2019 on the Government's response to the Tax Working Group.

How many people are likely to pay tax on capital gains every year?

6. Estimating the total number of people likely to be affected by an extension of the taxation of capital gains in New Zealand is difficult to determine due to data limitations.

7. In addition, substantial capital gains are likely to be earned through trusts, companies or managed funds. These entities can be owned by multiple individuals and so a capital gain earned by one entity can represent tax on multiple individuals. For example, taxing capital gains in New Zealand is likely to impact most New Zealanders with a KiwiSaver account. There are 2.9 million New Zealanders who have KiwiSaver accounts and it is difficult to estimate how many of these people would be impacted by taxing capital gains and by how much they would be impacted.

International evidence on likely number of individuals who would need to pay

8. International experience can provide some insight on the distributional impacts of taxing capital gains. International experience suggests that only a small number of individuals pay capital gains tax *directly* (i.e. the tax is paid by the individual rather than by an entity on behalf of the individual) in a given year. For example in:

    - *Australia:* 4.7% of individual income tax returns included capital gains in 2015.

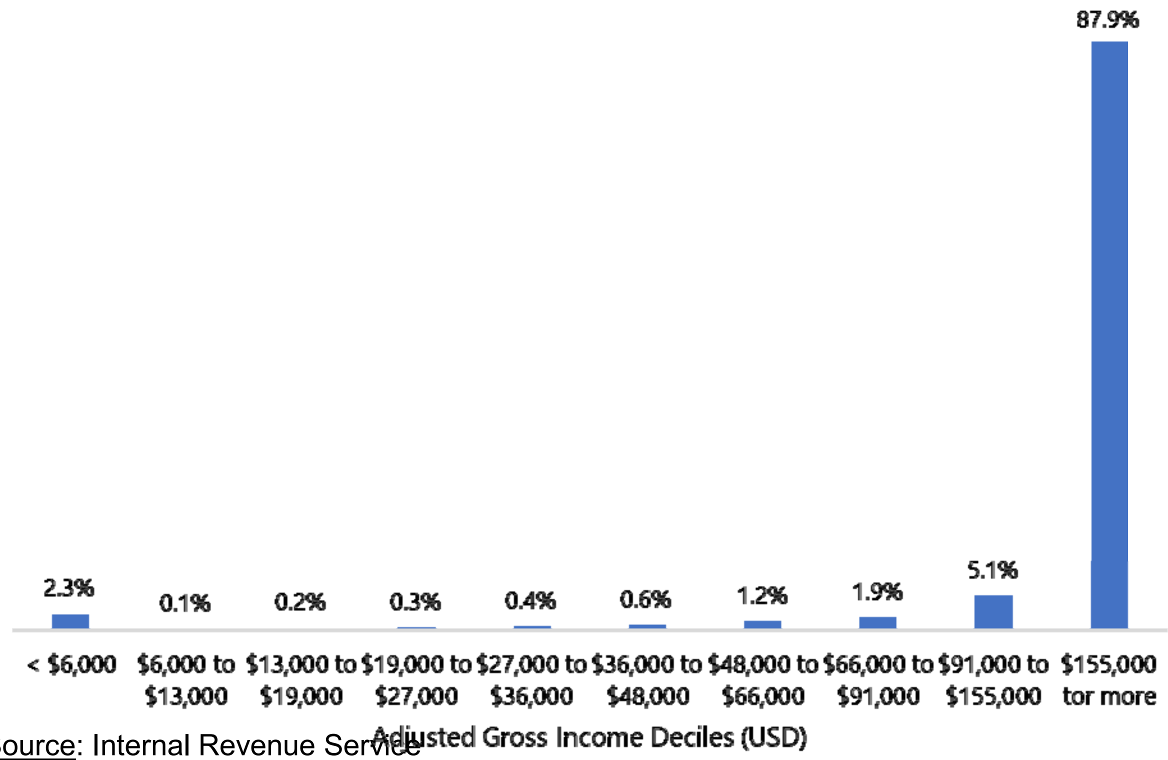
[1] Total estimated assets in these surveys do not exactly match estimates from aggregate data which is likely due to under-coverage of high-wealth households or under-reporting of assets in survey responses.

BUDGET-SENSITIVE

- *United States:* 7.8% of individual income tax returns included a taxable net gain from the sale of a capital asset, and 2.9% included a distribution of a capital gain from an entity (for example a trust distributing the proceeds of the sale of an asset) in 2015.
- *United Kingdom:* 0.8% of individual taxpayers had a capital gains tax liability in 2016/17.

9. The majority of these gains are paid by those with higher incomes. Figure 1 shows that in the United States close to 88% of capital gains are attributable to those in the top income decile.

Figure 1: United States income tax returns: percentage of capital gains by income band (2015)



Source: Internal Revenue Service

Note: This includes only those with a taxable net capital gain and excludes losses.

10. However, some of this progressivity arises from the fact that realised capital gains are lumpy. The size of the gains can push taxpayers into higher income brackets during the year when an asset is sold.

11. There is some international evidence to illustrate the size of this effect. In Australia, for example, taxpayer's in the top taxable income decile reported 70% of taxable capital gains. However, when looking at the distribution of gains by taxable incomes *before capital gains*, then only 40% of capital gains are earned by the top 10 percent of income earners[2]. This method of excluding capital gains will however, understate the progressivity of taxing capital gains. This is because excluding capital gains entirely removes a substantial proportion of these taxpayers total income.

What is the likely distributional impact of taxing capital gains in New Zealand?

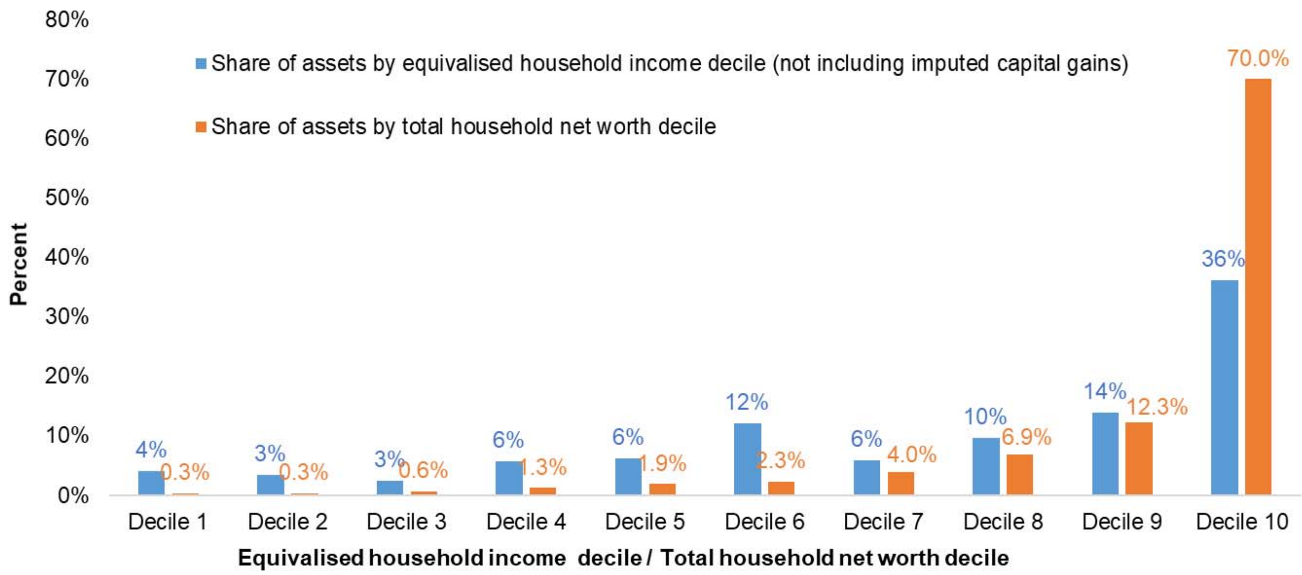
Wealth and income progressivity

2 Based on work from Daley and Wood.

12. The progressivity of a taxing capital gains can be measured by income or wealth. Usually we define progressivity in terms of income, however one of the potential effects of taxing capital gains is reducing wealth inequality and so the charts below primarily focus on the distribution by wealth[3].

13. Most assets that are potentially subject to a tax on capital gains are held by high income and high wealth households.

Figure 2: Ownership of assets by equivalised household income decile (excluding capital gains) and total household net worth decile (Figure 5.1 in Final Report)



<u>Source</u>: Statistics NZ (HES 2015); the Treasury.

Note: this chart shows the distribution of household assets, excluding cash, deposits and owner-occupied housing by household income and net worth decile. This is used as a proxy to indicate the potential distributional impact of capital gains taxation (the data used to construct the income deciles however, does not include income from capital gains).

Wealth and age

14. Some of the skewed distribution of wealth is attributable to households having different amounts of wealth through their lifetime. Figure 3 shows that younger individuals generally have less wealth than older individuals.

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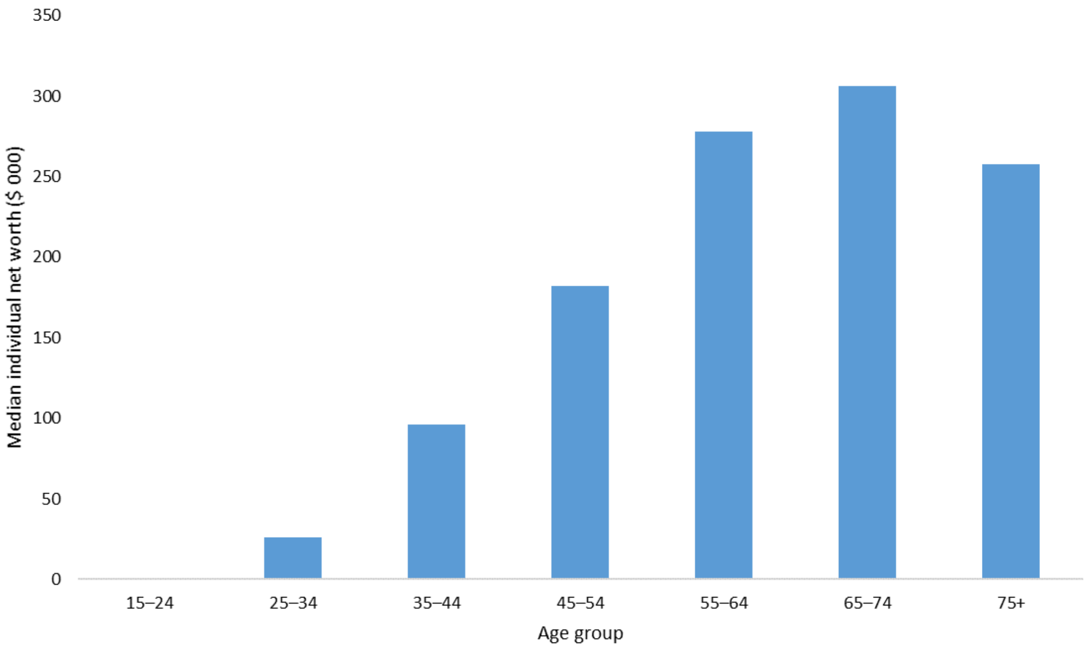
3 In addition, estimating the impact of taxing more capital gains by incomes is difficult because income measurements in the data exclude capital gains. Once capital gains are included, many households in lower income deciles would need to be "re-ranked" and placed into higher income deciles. Without this re-ranking the impact of taxing capital gains on lower-income households will be overstated. However, this "re-ranking" is generally not feasible within the data.

Figure 3: Median individual net worth by age group (2015)



Source: Statistics NZ (HES 2015); the Treasury

15. The analysis below considers the legal incidence of a taxing capital gains (who would legally be required to pay the tax on capital gains). The economic incidence of taxing capital gains can be different (where the cost of a tax can be borne by others, for example through higher rents).

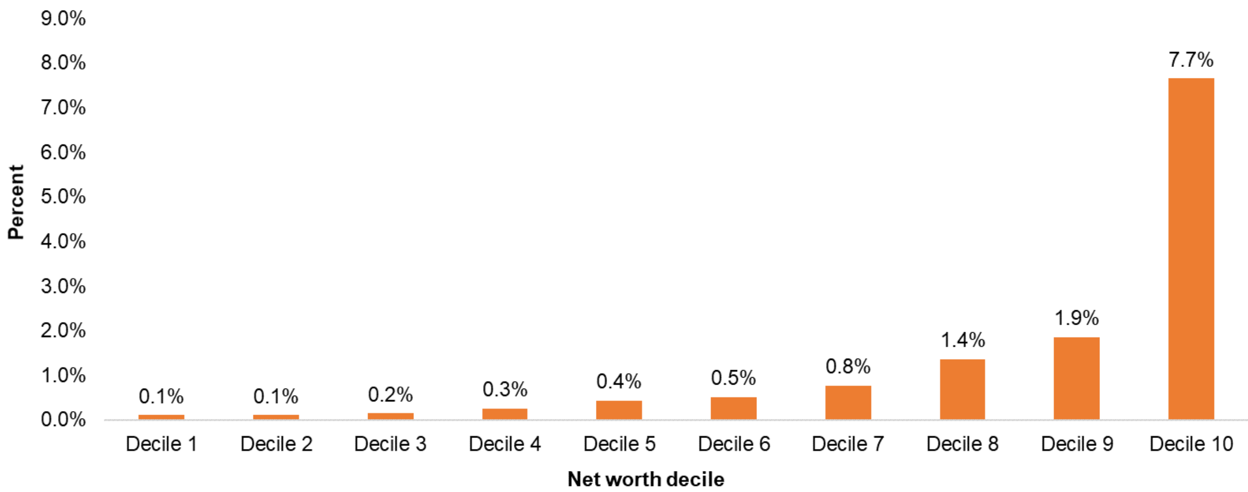
Distributional impact of extending the taxation of capital gains

16. Taxing capital gains is likely to be progressive. In particular, it is likely to be paid mostly by those with high wealth.

17. Figure 4 shows the estimated distributional impact of taxing capital gains for each net worth decile in New Zealand. This estimate is based on attributing the projected revenue from taxing capital gains to households based on their ownership of assets. It assumes all revenue from taxing capital gains (including tax paid by companies and trusts) is attributable to the owner.

18. Figure 4 shows the estimated capital gains liability as a percentage of *disposable* (i.e. after-tax) income. This effectively estimates how much of households' after tax income (excluding capital gains) will be required to pay the capital gains liability. However, this shows the average annual tax liability and will not show the actual cashflow impact for households associated with a realisation based tax which is expected to be lumpy.

Figure 4: Estimated annual average capital gains liability as percentage of disposable income by net worth decile



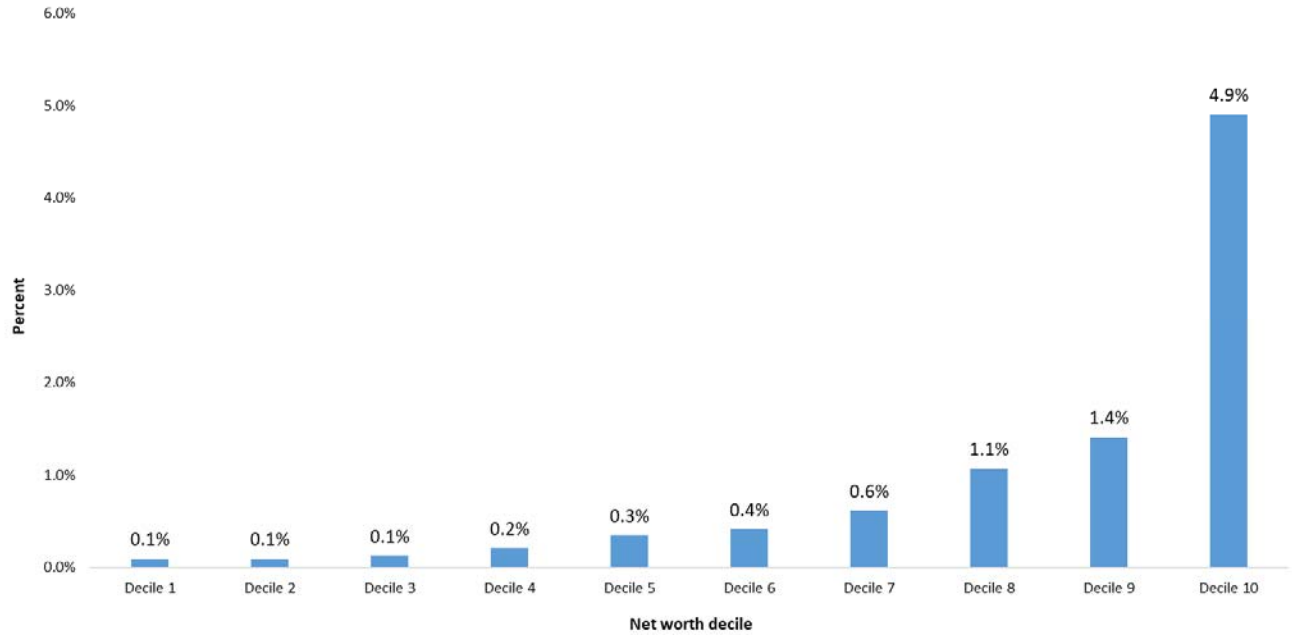
<u>Source</u>: Statistics NZ (HES 2015); the Treasury

Note: These estimates are based on the share of total household net worth that could be subject to capital gains taxation by household net worth decile, and projected revenue from the taxation of capital gains. Estimates for revenue from capital gains taxation are for the fifth year after introduction, discounted to tax year 2021/22 (when the tax is proposed to come into effect). Estimates are preliminary and indicative.

These estimates do not attribute the impact of taxing capital gains earned by managed funds to individual investors. However, the impact of this is likely to be small as managed funds hold only a small proportion of their assets in domestic shares and the Group did not recommend applying a capital gains tax to most foreign shares held by managed funds.

19. Figure 5 shows the estimated capital gains liability as a proportion of household's *total gross income including imputed capital gains.* This shows how much of a household's gross income (including capital gains) will be required to pay their estimated capital gains liability.

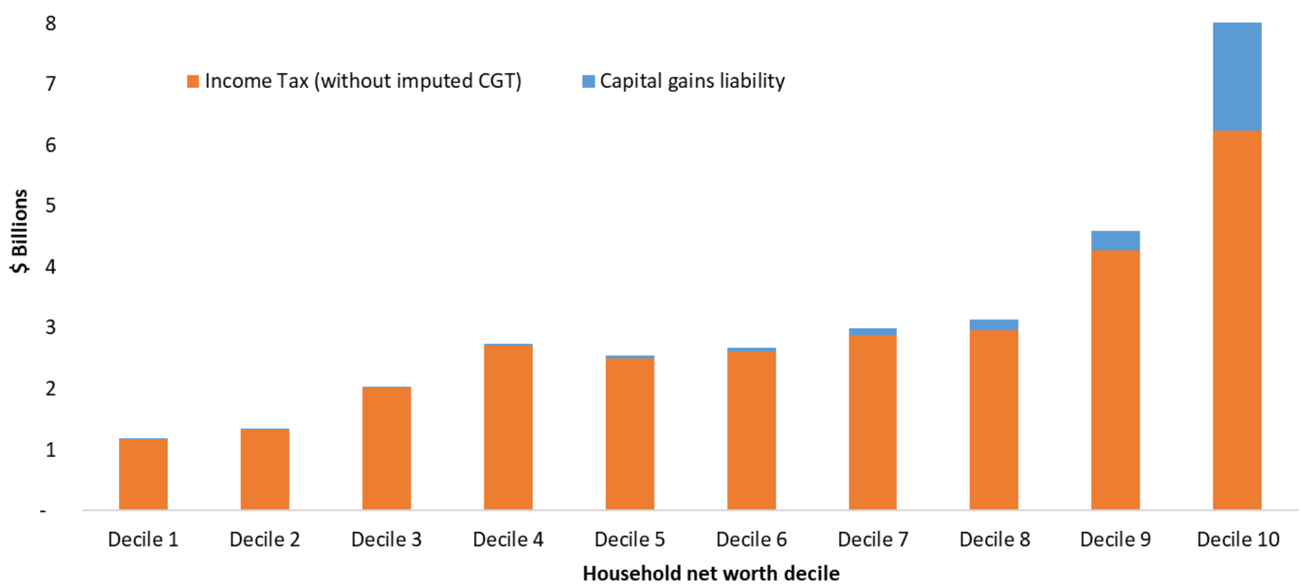
Figure 5: Estimated capital gains liability as a proportion of household's total gross income including imputed capital gains



Note: The calculation of total gross income includes taxable income as well as non-taxable transfers and other non-taxable private income. Calculation of gross income is net of the ACC levy but not income tax.

20. Figure 6 shows the estimated increase in overall increase in tax liability in absolute dollar terms from taxing more capital gains by household net worth decile. The estimated average increased tax for households in decile 1 is $50 per annum or a 0.7% increase in their tax liability (this is based on estimated capital gains in 2025/26 discounted to 2021/22) while the estimated increase in tax for households in decile 10 is $10,800 which is a 29% increase in their tax liability.

Figure 6: Personal income tax and estimated CGT liability by net worth decile



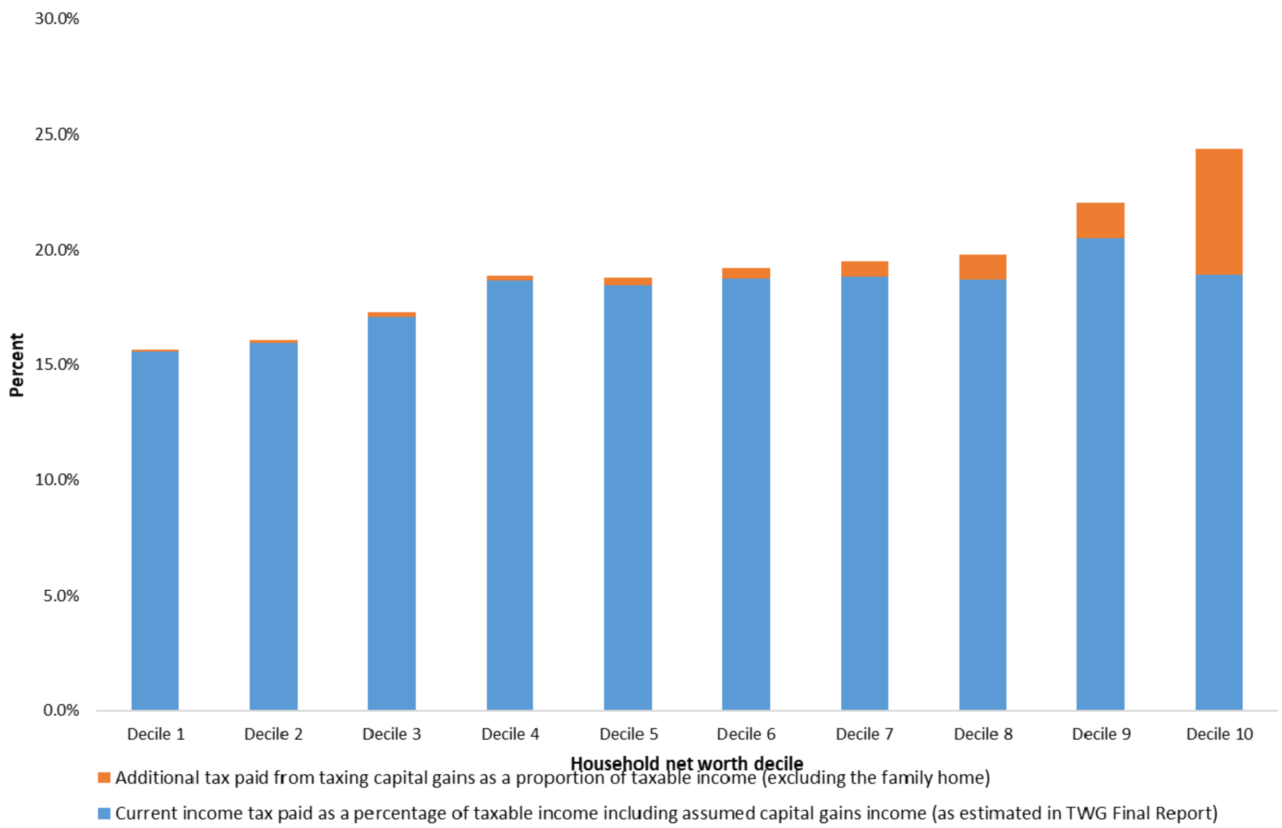
<u>Source</u>: Statistics NZ (HES 2015); the Treasury

Note: Estimates for revenue from taxing capital gains are for the fifth year after introduction, discounted to tax year 2021/22 (when the tax is proposed to come into effect). Estimates are preliminary and indicative.

21. Figure 7 shows the estimated impact of taxing capital gains on the average effective tax rate for households in each wealth decile. The grey line shows an estimate of the current average effective income tax rate on household's income when untaxed capital gains are included in their income. The blue line shows an estimate of their effective tax rate when these untaxed capital gains are taxed. The effective tax rate for those in decile 10 increases from 19% to 24% as a result of the taxation of capital gains.

22. As Figure 7 shows, when capital gains are untaxed, households in the top net worth decile are estimated have a lower effective income tax rate than those in decile 9. This is because those in decile 10 have a greater amount of untaxed income from capital gains. However, this actual distributional impact of taxing capital gains is subject to considerable uncertainty and Figure 7 is an estimate based on the modelling assumptions used (including an assumption of 3% annual price increases).

Figure 7: Average effective income tax rates by household net worth decile



Source: Statistics NZ (HES 2015); the Treasury

Notes: Capital gains: The estimates for capital gain used in this analysis are from the Tax Working Group Final Report. The share of capital gains tax liability by household net worth decile is based on the share of assets (excluding cash, deposits and owner occupied housing) by household net worth decile. Capital gains tax revenue estimates have been discounted to tax year 2021/22 (assuming 3 percent annual capital gain, and taxed at an average marginal tax rate of 26 %). Revenue from taxing more capital gains will be low in the first 4 years after implementation. For this reason, revenue from taxing more capital gain is discounted from year 5, or tax year 2025/26. The imputed capital gains excludes gains that would be subject to rollover relief.

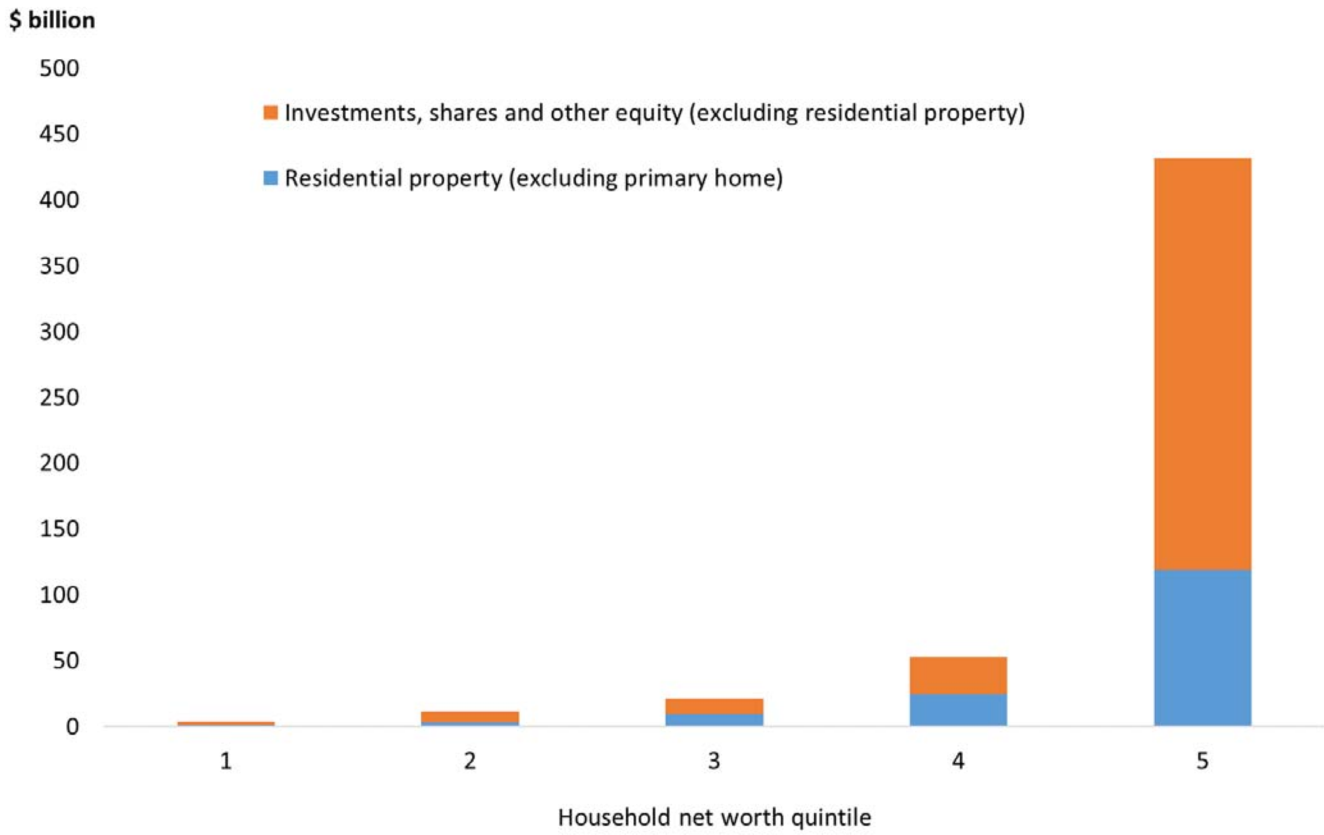
Data: Although the taxation of capital gains is envisaged to take effect after tax year 2021/22, the corresponding data on personal income tax by household net worth decile is not available for this period. The data for household economic survey used is for 2014/15. While Stats NZ released Household Economic Survey 2018 (for tax year 2017/18) in December 2018, the underlying data is not yet available for the purpose of this analysis.

Distributional impact of minority recommendation

23. A minority of the Tax Working Group recommended extending the taxation of capital gains solely to residential investment property. This is likely to be less progressive than a broad-based extension of the taxation of capital gains.

24. Figure 8 below shows that taxing residential property and other investment assets are both likely to be progressive with regards to wealth. However, non-residential investments are more concentrated among the wealthiest household quintile, so taxing these assets is expected to be more progressive than taxing residential investment property only. The wealthiest quintile own 86% of non-residential investments and 75% of residential property (excluding the primary home).

Figure 8: Selected assets by household net worth quintile



Source: Statistics NZ (HES 2015); the Treasury, Inland Revenue[4]

25. Figure 9 shows how much of each asset type is owned by each household net worth quintile. It shows that the ownership of assets potentially subject to an extension of the taxation of capital gains are skewed towards the highest net worth quintile.

[4] There are some limitations to this data. As outlined earlier there is uncertainty in the estimates due to lack of available information. In addition, some of the financial assets will be debt securities and other assets which are already comprehensively taxed. However, we expect the majority of the financial assets will be shares and equity in businesses. In addition, the attribution of assets from trusts and businesses to individuals is imprecise.

Figure 9: Percentage of assets owned by each household net worth quintile[5]

	1	2	3	4	5
Investments, shares and other equity (excluding residential property)	0.7%	2.3%	3.2%	7.7%	86.2%
Residential property (excluding primary home)	0.8%	2.1%	6.1%	15.8%	75.2%
Primary home	0.9%	5.6%	17.9%	28.1%	47.5%
Currency and other assets	3.1%	10.2%	15.1%	21.9%	49.7%

Source: Statistics NZ (HES 2015); the Treasury, Inland Revenue[6]

26. Figure 10 shows the composition of each household's asset portfolio by net worth decile. Figure 10 shows that the highest net worth decile invest a greater proportion of their wealth into non-residential assets than other net worth deciles.

Figure 10: Percentage of household assets for each household net worth quintile

	1	2	3	4	5
Investments, shares and other equity (excluding residential property)	16.3%	13.7%	8.5%	12.2%	41.1%
Residential property (excluding primary home)	8.0%	5.4%	7.1%	10.8%	15.6%
Primary home	26.3%	40.6%	57.6%	53.8%	27.4%
Currency and other assets	47.6%	39.6%	26.2%	22.5%	15.4%

Source: Statistics NZ (HES 2015); the Treasury, Inland Revenue[7]

How would taxing capital gains affect particular industries?

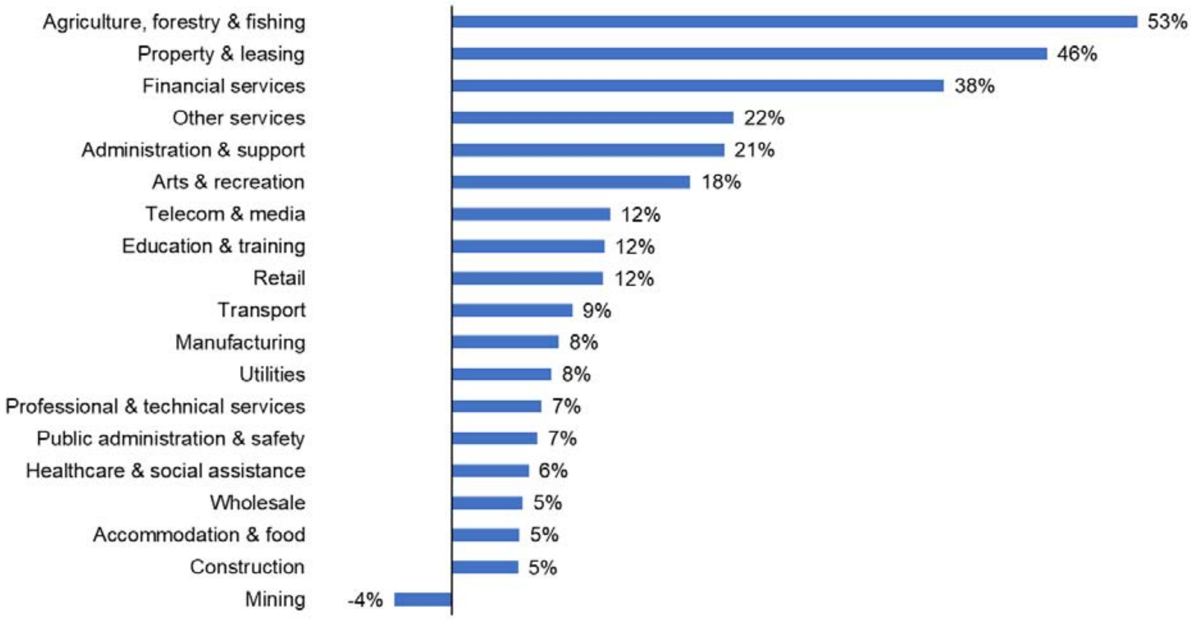
27. An extension of the taxation of capital gains is likely to have an uneven impact across industries. Figure 11 shows the untaxed realised gains as a proportion of the total accounting profit for different industries. This shows that capital gains make a significant part of the accounting income for the property, agricultural and finance sector.

5 Numbers do not add to 1 due to rounding and imprecision in some of the adjustments made.

6 There are some limitations to this data. As outlined earlier there is uncertainty in the estimates due to lack of available information. In addition, some of the financial assets will be debt securities and other assets which are already comprehensively taxed. However, we expect the majority of the financial assets will be shares and equity in businesses. In addition, the attribution of assets from trusts and businesses to individuals is imprecise.

7 There are some limitations to this data. As outlined earlier there is uncertainty in the estimates due to lack of available information. In addition, some of the financial assets will be debt securities and other assets which are already comprehensively taxed. However, we expect the majority of the financial assets will be shares and equity in businesses. In addition, the attribution of assets from trusts and businesses to individuals is imprecise.

Figure 11: Untaxed realised gains as a proportion of total accounting profit by industry (2013-2017)



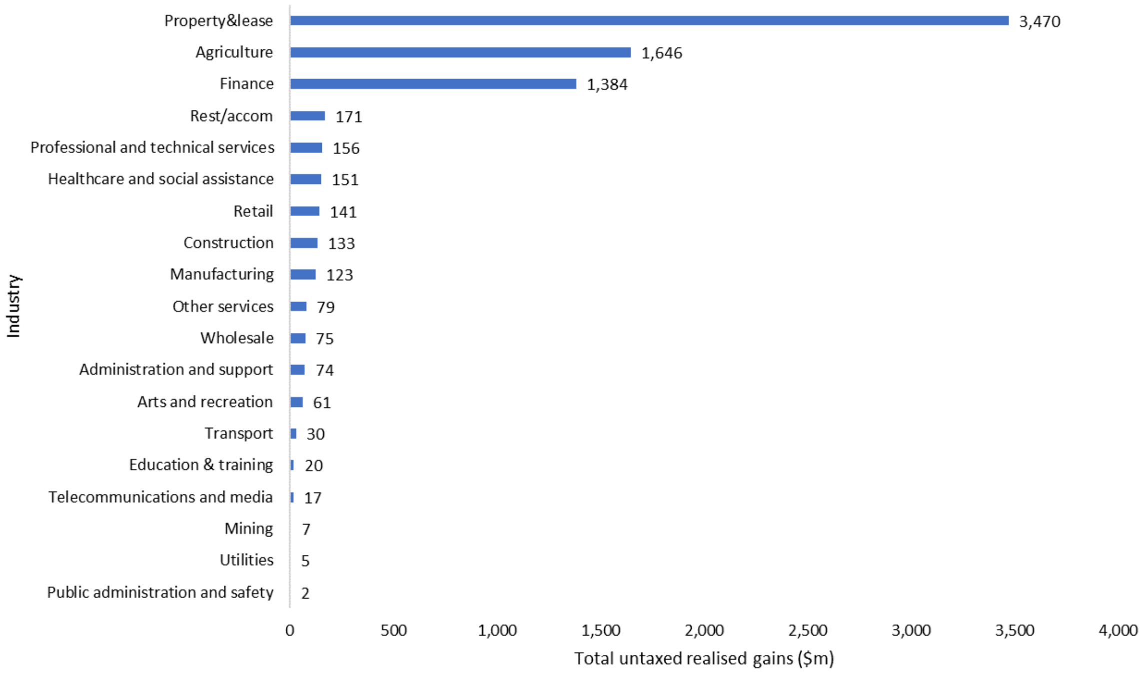
<u>Source:</u> Inland Revenue (IR 10)

Note: Figures 11 and 12 should be considered as an indicative view of capital gains earned by small and medium enterprises in New Zealand excluding a significant proportion of residential property owners. This is because the data used for these figures does not include most large businesses and a significant number of those in the residential property industry.

The finance industry in these charts is generally made up of "holding companies". These are closely-held companies holding investment assets for their owners.

28. Figure 12 shows the total amount of untaxed realised gains in 2017 for each of these industries.

Figure 12: Total untaxed realised gains by industry (2017)



Source: Inland Revenue (IR 10)

14.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: TWG final report – officials' companion advice, table of recommendations

Date:	14 February 2019	**Report No:**	T2019/243 IR2019/062
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Indicate** recommendations you would like further advice on**.**	25 February 2019
Minister of Revenue (Hon Stuart Nash)	**Indicate** recommendations you would like further advice on.	25 February 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Matthew Gan	Tax Specialist, The Treasury	s9(2)(a)	N/A	
Jordan Ward	Team Leader, The Treasury		s9(2)(a)	
Emma Grigg	Policy Director, Inland Revenue			✓

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: TWG final report – officials' companion advice, table of recommendations

1. The Tax Working Group's (TWG's) Final Report makes 99 recommendations. This report:

   a. provides officials' initial high-level views on each recommendation;

   b. suggests how the Government could respond; and

   c. seeks your direction on recommendations you would like further advice on.

2. This report is focused on recommendations not relating to the taxation of capital gains and supplements advice provided on 1 February (T2019/113, IR2019/041 refers).

3. Officials' views are provided on an on-exceptions basis (for example, where officials have a different view to the TWG). This reflects officials' advice provided to the Tax Working Group. Supporting analysis is typically contained in relevant Secretariat papers. We have also noted where you have already received advice relating to the recommendation, as well as links to other work programmes.

4. Suggested approaches to respond to the TWG's recommendations are classified into four colour-coded categories:

No further work (NFW)	Green: A decision has been made and/or no further work is required.
Work underway (WU)	Blue: Work is already underway in the Treasury/Inland Revenue or another agency.
Mid-year package (MYP)	Yellow: Could be considered for inclusion in a mid-year package announcement.
Work programme (WP)	Orange: Could be considered for the Tax Policy Work Programme (a refresh is scheduled for mid-2019)/other agency work programme and/or require further advice.

High-level summary

5. The table below provides a high-level summary of the TWG recommendations by key topic area. See Table 1 in the body of the report for the full recommendations and officials' suggested response.

Topic	Summary of TWG recommendations	Status
Capital and wealth	Do not introduce wealth or land taxes.	NFW
	Broad extension of capital gains taxation.	MYP

Environmental and ecological outcomes	Adopt TWG's framework for taxing negative environmental externalities.	WP
	Opportunities for resource-specific taxes (strengthen ETS and Waste Disposal Levy, progress congestion charging, consider water pollution/abstraction taxes).	WU
The taxation of business	The current approach to the taxation of business is largely sound. Retain the imputation system. Do not reduce the company tax rate. Do not introduce different rates for small businesses.	NFW
	Various revenue-negative measures to support businesses considered as part of tax package options (loss continuity rules, blackhole expenditure, building depreciation, rental loss ring-fencing removal, compliance cost measures).	MYP
International income taxation	Stand ready to respond to international developments. Keep participating in the OECD discussions.	WU
Retirement savings	Various KiwiSaver measures targeted at low-income earners (refunding the Employer Superannuation Contribution Tax, increasing the member tax credit, reducing lower PIE rates for KiwiSaver funds).	MYP
Future of work	Tax system needs to remain fit for purpose in light of labour market changes. Support for IR's work on self-employed compliance work.	WU
Integrity of the tax system	Continued vigilance needed. Various measures recommended (review loss-trading rules, require shareholders in a closely-held company to provide security to IR, further action to address the hidden economy).	WP
Personal income tax	Various revenue-negative personal tax changes considered as part of tax package options. Preferred approach is increasing bottom threshold, although welfare transfers might be preferable. Support flow through of tax changes to benefits.	MYP
Administration of the tax system	Greater public access to data and information about the tax system. Improvements to the resolution of tax disputes (truncated disputes resolution process)	WP
Charities	Key issue identified is distribution practices and rules. Recommends periodic review of the charitable sector's use of what would otherwise be tax revenue, to verify that the intended social outcomes are being achieved.	WU
GST	No changes to GST. No financial transaction tax. The Government should monitor international developments regarding GST on financial services.	NFW
Corrective taxes	Alcohol: Simplify alcohol excise rate structure. Tobacco: prioritise non-tax levers. Sugar and gambling: clearer articulation of Government's objectives needed.	WP
Housing	Changes to capital gains taxation are main recommendations impacting housing, although impacts will likely be marginal. Various additional measures (disclosure of IRD number when purchasing a main home, repeal the "ten-year rule", consider vacant land taxes as part of Productivity Commission review of local government funding and financing).	WP

6. The TWG has also written to you advising how tikanga Māori could be better incorporated into tax policy. This work is now being progressed by the Treasury as part of their work on the Living Standards Framework. The Secretary to the Treasury will update you on how the Treasury intends to progress this work before the release of the TWG Final Report.

Recommended Action

We recommend that you:

a **Note** the contents of this report.

Noted/Not noted *Noted/Not noted*

b **Indicate** in Table 1 whether you wish to receive further advice on any particular Tax Working Group recommendation(s).

c **Discuss** with officials how you would like to respond to the Tax Working Group's recommendations.

Jordan Ward
Team Leader
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance

/ /2019

Hon Stuart Nash
Minister of Revenue

/ /2019

TABLE 1: RECOMMENDATIONS OF THE TAX WORKING GROUP

The table below lists all 99 recommendations in the Tax Working Group's Final Report, with the following columns:

- **Status:** Indicates the status of the recommendation as per the table key below.
- **Officials' comment:** Officials' views are provided on an on-exceptions basis (for example, where officials have a different view to the TWG). This reflects officials advice provided to the Tax Working Group. Supporting analysis is typically contained in relevant Secretariat papers. We have also noted where you have already received advice relating to the recommendation, as well as links to other work programmes.
- **Further info?:** Space for you to indicate if you would like to receive further advice on particular recommendations.

Table key:

No further work (NFW)	A decision has been made and/or no further work is required.
Work underway (WU)	Work is already underway in the Treasury/Inland Revenue or another agency.
Mid-year package (MYP)	Could be considered for inclusion in a mid-year package announcement.
Work programme (WP)	Could be considered for the Tax Policy Work Programme (a refresh is scheduled for mid-2019)/other agency work programme and/or require further advice

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
Extension of Capital Gains				
1	The majority of the TWG recommends a broad extension of the taxation of capital gains.	MYP	See *Tax Working Group final report – officials' companion advice* (T2019/113, IR2019/041 refers).	
2	If a broad extension of capital gains taxation was adopted, the TWG recommends that it have the characteristics detailed in Volume II of their report.	MYP		

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
Capital and wealth				
3	Do not introduce a wealth tax.	NFW	In responding to the Interim Report, the Government confirmed it is comfortable that no further work is undertaken on wealth and land taxes.	
4	Do not introduce a land tax.	NFW		
Environmental and ecological outcomes				
5	Adopt the TWG's framework for taxing negative environmental externalities.	WP		
6-8	***Greenhouse gases*** a) Support for a reformed Emissions Trading Scheme (ETS) as the centrepiece of emissions reduction efforts, but there should be greater guidance on price and auctioning emission units to raise revenue. b) Periodic reviews of the ETS to ensure it is fit for purpose. c) Emissions should face a price, including from agriculture, either from ETS or a complementary system.	WU	ETS reforms are currently being considered as part of the Climate Change Response Act Amendment Bill. The Interim Climate Change Committee (ICCC) is considering the treatment of agricultural emissions in the ETS and will make a decision by April 2019.	
9-11	***Water abstraction and water pollution*** a) Tax instruments could be considered to address water pollution and water abstraction challenges. b) Further develop tools to estimate diffuse water pollution. c) Introduce input-based tax instruments, including on fertiliser, if significant progress is not made in the near term on output-based approaches.	WU	The Water Taskforce is working to achieve improvements in water quality as well as efficient and fair allocation of freshwater and nutrient discharges. Initial consultation on discharge approaches is expected in mid-2019.	
12-15	***Solid waste*** a) Supports the Ministry for the Environment's review of the rate and coverage of the Waste Disposal Levy. b) Expand the coverage of the Waste Disposal Levy. c) Reassess the negative externalities associated with landfill disposal in New Zealand to ascertain if a higher levy is appropriate.	WU	The Ministry for the Environment is currently reviewing the Waste Disposal Levy and is due to report to Ministers by October 2019. In respect of (d), officials consider the use of funds should not be restricted to circular economy initiatives.	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	d) Review hypothecation of the Waste Disposal Levy to ensure funds are being used in the most effective way to move towards a more circular economy.			
16	***Transport*** Supports current reviews by the Government and Auckland Council into introducing congestion pricing.	WU	The Congestion Question project's Phase II report is due to Ministers mid-2019.	
Concessions				
17	Costs associated with the care of land subject to a QEII covenant or Ngā Whenua Rāhui be tax deductible.	WP	If this measure was to progress, the concession should not be overly broad such that it would allow deductions for expenses that have no connection to a business or other taxable activity.	
18	Consider an FBT exemption for public transport.	WP	Officials would need to analyse the benefits of having an exemption for public transport, versus the integrity and fiscal costs. Incentives for purchasing electric vehicles is being progressed as a Budget 2019 bid.	
19	Review various tax provisions specific to farming, forestry and petroleum mining with a view to removing concessions harmful to natural capital, while also considering new concessions that could enhance natural capital.	WP		
Other environmental recommendations				
20	Recycle some or all of the revenue raised by environmental taxes into measures that support the transition to a more sustainable economy.	WP	Officials do not recommend strict hypothecation. Recycling revenue raised by auctioning is an option being considered as part of reforms to the ETS. Revenue recycling already occurs with the Waste Disposal Levy.	
21	Over the longer term, consider an environmental footprint tax or a natural capital enhancement tax.	WP		
22	The Government should strengthen its environmental tax capabilities, including with the Parliamentary Commissioner for the Environment.	WP		
23	Commission incidence studies on environmental taxes.	WU	The assessments of distributional impacts of environmental taxes can	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
			be carried out as part of consideration of specific environmental tax initiatives.	
24	Undertake further work to assess how taxes can complement other environmental policy measures and to work through the design principles in the TWG's framework for taxing negative environmental externalities.	WP		
The taxation of business				
25	Retain the imputation system.	NFW		
26	Do not reduce the company tax rate at the present time.	NFW		
27	Do not introduce a progressive company tax.	NFW		
28	Do not introduce an alternative basis of taxation for smaller businesses, such as a cash flow or turnover taxes.	NFW		
29	Retain the 17.5% rate for Māori authorities.	NFW		
30	Extend the 17.5% rate to the subsidiaries of Māori authorities.	WP		
31	Consider technical refinements to the Māori authority rules, as suggested by submitters, in the Tax Policy Work Programme.	WP		
32	Change the loss continuity rules to support the growth of innovative start-up firms.	MYP	See *Tax Working Group final report – officials' companion advice* (T2019/113, IR2019/041 refers).	
33	Reform the treatment of black-hole expenditure by spreading such expenditure over five years with a $10,000 safe-harbour threshold of upfront deducts for feasibility expenditure.	MYP		
34	Consider restoring depreciation deductions for buildings if there is an extension of the taxation of capital gains (subject to fiscal constraints). To manage the fiscal costs, the Government could reinstate building depreciation on a partial basis for: a) seismic strengthening only; b) multi-unit residential buildings; or c) industrial, commercial, and multi-unit residential buildings.	MYP		
35	Consider tax measures that encourage building to higher	WP	Officials' do not support these measures.	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	environmental standards.			
36	Consider developing a regime that encourages investment into nationally-significant infrastructure projects.	WP		
37	Examine the following options to reduce compliance costs: *For immediate action:* a) Increasing the threshold for provisional tax from $2,500 to $5,000 of residual income tax. b) Increasing the closing stock adjustment from $10,000 to $20,000 - $30,000. c) Increasing the $10,000 automatic deduction for legal fees, and a potential expansion of the automatic deduction to other types of professional fees. d) Reducing the number of depreciation rates, and simplifying the process for using default rates. *Subject to fiscal constraints:* e) Simplifying the fringe benefit tax, and simplifying (or even remove) the entertainment adjustment. f) Removing resident withholding tax on close company-related party interest and dividend payments, subject to integrity concerns. g) Removing the requirement for taxpayers to seek the approval of the Commissioner of Inland Revenue to issue GST Buyer Created Tax Invoices. h) Allowing special rate certificates and certificates of exemption to be granted retrospectively. i) Increasing the period of validity for a certificate of exemption or special rate certificate. j) Removing the requirement to file a change of imputation ratio notice with Inland Revenue. k) Extending the threshold of 'cash basis person' in the financial arrangement rules which would better allow for the current levels of personal debt. l) Increasing the threshold for not requiring a GST change of use adjustment. *The Government should also review and explore opportunities to:* m) Adjust the thresholds for unexpired expenditure, and for the write-	MYP	See *Small business tax measures* (T2019/239, IR2019/049 refers).	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	off of low value assets. n) Help small businesses reduce compliance costs through the use of cloud-based accounting software. o) Consider compensation for withholding agents if additional withholding tax obligations are imposed. p) Review the taxation of non-resident employees. q) Review whether the rules for hybrid mismatches should apply to small businesses or simple business transactions.			
38	Give favourable consideration to exempting the New Zealand Superannuation Fund from New Zealand tax obligations.	WP	See *Further Information on TWG issues raised* (T2019/175, IR2019/031 refers).	
International income taxation				
39	New Zealand should continue to participate in the OECD discussions on the future of the international tax framework.	WU		
40	The Government should stand ready to implement a digital services tax if a critical mass of other countries move in that direction, and it is reasonably certain New Zealand's export industries will not be materially impacted by any retaliatory measures.	WU	Cabinet approval is being sought to release a discussion document for public consultation on options for taxing the digital economy, including a digital services tax, (T2019/171, IR2019/038 refers).	
41	New Zealand should actively monitor developments and collaborate with other countries with respect to equalisation taxes.	WU		
42	Ensure, to the extent possible, that our double tax agreements and trade agreements do not restrict our taxation options in these matters.	WU		
Retirement savings				
43	Consider encouraging the savings of low-income earners by carrying out one or more of the following: a) Refunding the Employer Superannuation Contribution Tax (ESCT) for KiwiSaver members earning up to $48,000 per annum. This refund would be clawed back for KiwiSaver members earning more than $48,000 per annum, such that members earning over $70,000 would receive no benefit. b) Ensuring that a KiwiSaver member on parental leave would receive the maximum member tax credit regardless of their level of	MYP	Officials recommend a broader range of measures (including non-income tax measures) be considered to assist low-income earners to achieve distributional objectives. Officials recommend delaying any design decisions on personal tax and welfare settings until later in 2019 to allow time to consider the Welfare Expert Advisory Group's (WEAG) recommendations and to develop an integrated personal tax and transfer package. See *Tax Working Group final report – officials' companion advice*	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	contributions. c) Increasing the member tax credit from $0.50 per $1 of contribution to $0.75 per $1 of contribution. The contribution cap should remain unchanged. d) Reducing the lower PIE rates for KiwiSaver funds (10.5% and 17.5%) by five percentage points each.		(T2019/113, IR2019/041 refers).	
44	Consider ways to simplify the determination of the PIE rates (which would apply to KiwiSaver).	WP		
Personal income tax				
45	Recommendations on personal tax are dependent on the objectives of the Government: a) If the Government wishes to improve incomes for very low income households, the best means of doing so will be through welfare transfers. b) If the Government wishes to improve incomes for certain groups of low to middle income earners, such as full-time workers on the minimum wage, then changes to personal income taxation may be a better option.	MYP	Officials recommend delaying any design decisions on personal tax and welfare settings until later in 2019 to allow time to take into account the Welfare Expert Advisory Group's (WEAG) recommendations and to develop an integrated personal tax and transfer package. s9(2)(f)(iv)	
46	Consider increases in the bottom threshold of personal tax to increase the progressivity of the personal tax system.	MYP	s9(2)(f)(iv)	
47	Consider combining increases in the bottom threshold with an increase in the second marginal tax rate.	MYP		
48	Suggests that if (47) is adopted, consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase.	MYP		
49	Prefer increasing the bottom threshold to introducing a tax-free threshold.	MYP		
50	Consider an increase in net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same	MYP		

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	income.			
51	Consider changes to tax rates and thresholds alongside any recommendations made by WEAG.	MYP		
52	No reduction in the top marginal tax rate because it is already low by international standards and it would not increase progressivity of the tax system.	NFW		
53	The TWG notes that many submissions called for increasing tax personal tax rates to make a material reduction in income equality through the personal tax system. These increases are precluded by the TWG's Terms of reference and the TWG did not undertake an analysis of the options (and their effectiveness).	NFW	Outside of the scope of the TWG.	
Future of work				
54	Support Inland Revenue's efforts to increase the compliance of the self-employed, particularly expanding the use of withholding tax as far as practicable, including to platform providers such as ride-sharing companies.	WU	Budget funding has been allocated, and this is on the Government's current tax policy work programme.	
55	Support the facilitation of technology platforms to assist the self-employed meet their tax obligations through the use of 'smart accounts' or other technology based solutions.	WU		
56	Continue (through Inland Revenue's current work) to use data analytics and matching information to specific taxpayers to identify underreporting of income.	WU		
57	Review the current GST requirements for contractors who are akin to employees.	WP		
58	Align the definition of employee and dependent contractor for tax and employment purposes.	WP	Will require consultation with the Ministry of Business, Innovation and Employment.	
59	Provide more support for childcare costs, with this support best provided outside the tax system.	WP		
Integrity of the tax system				

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
60	A review of loss-trading, potentially in tandem with a review of the loss continuity rules for companies.	MYP	Consider as part of recommendation 32.	
61	Inland Revenue should have the ability to require a shareholder in a closely-held company to provide security to Inland Revenue if: a) The company owes a debt to Inland Revenue; and b) The company is owed a debt by the shareholder; and c) There is doubt as to the ability/and or the intention of the shareholder to repay the debt.	WP		
62	Further action in relation to the hidden economy, including: a) An increase in the reporting of labour income (subject to not unreasonably increasing compliance costs on business). b) A review of the measures recently adopted by Australia in relation to the hidden economy, with a view to applying them in New Zealand. c) The removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.	WU	See *Budget 2018: Self-employed Compliance Initiatives,* IR2018/734	
63	That Inland Revenue continue to invest in the technical and investigatory skills of its staff.	WU	Inland Revenue continues to invest in staff skills and capabilities, and this will be monitored on an ongoing basis.	
64	Further measures to improve collection and encourage compliance, including: a) Making directors who have an economic ownership in the company personally liable for arrears on GST and PAYE obligations (as long as there is an appropriate warning system). b) Departure prohibition orders. c) Aligning the standard of proof for PAYE and GST offences.	WP		

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
65	The establishment of a single centralised Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.	WP	s9(2)(f)(iv) The establishment of a single debt collection agency for government debt would require significant consultation between government agencies and many of the benefits may instead be realised from additional information sharing.	
66	That Inland Revenue strengthens enforcement of rules for closely-held companies.	WP		
67	Explore options to enable the flexibility of a wider gap between the company and the top personal tax rate without a reduction in the integrity of the tax system.	WP		
Administration of the tax system				
Tax secrecy and tax transparency				
68	The Government should: a) Fund oversampling of the wealthy in existing wealth surveys. b) Include a question on wealth in the census. c) Request Inland Revenue regularly repeat its analysis of the tax paid by high wealth individuals. d) Commission research on using a variety of sources of data on capital income, including administrative data, to estimate the wealth of individuals.	WP		
69	The TWG strongly encourages the Government to release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available). The Government could consider further measures to increase transparency as public attitudes change	WP		

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	over time.			
70	The TWG encourages Inland Revenue to publish or make available a broader range of statistics, in consultation with potential users, either directly or (preferably) through Statistics New Zealand.	WP		
71	The TWG encourages Inland Revenue to collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.	WP	Officials consider this is best achieved in an overall programme to provide better quality information to Inland Revenue in general. More detailed information on environmental income and expenditure should naturally flow from taxpayers supplying more detailed financial information, especially for larger taxpayers.	
Ombudsman				
72	Any further expansion of the resources available to the Ombudsman should include consideration of provision for additional tax expertise, and possibly support to manage any increase in the volume of complaints relating to the new Crown debt collection agency proposed by the TWG.	WP	We consider the Ombudsman should decide where they would like additional expertise.	
Taxpayer advocate service				
73	Establish a taxpayer advocate service to assist with the resolution of tax disputes.	NFW	Inland Revenue have reported on this matter and no further work has been requested by Ministers at this point (see IR2018/762).	
74	Consider a truncated tax disputes process for small taxpayers.	WP		
The development of tax policy				
75	The following principles should be applied in public engagement on tax policy: a) Good faith engagement by all participants. b) Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Crown/Māori relations). c) Earlier and more frequent engagement. d) The use of a greater variety of engagement methods. e) Greater transparency and accountability on the part of the	WU	These principles have been included in a draft engagement framework which officials intend to release, subject to Ministerial approval (T2018/3292, IT2018/654 refers).	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
	Government.			
76	The TWG notes the need for the Treasury to play a strong role in tax policy development, and the importance of Inland Revenue maintaining deep technical expertise and strategic policy capability.	WU	Following a strategic review in mid-2017, the Treasury substantially increased its tax policy capability and it intends to broadly maintain this higher resource level over the medium term.	
Legislative frameworks				
77a	The TWG encourages the continuing use of purpose clauses where appropriate.	NFW		
77b	The inclusion of an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.	WP	Extensive consultation needed with Crown Law and the Legislation Design and Advisory Committee.	
Charities				
78	Periodically review the charitable sector's use of what would otherwise be tax revenue to verify that intended social outcomes are being achieved.	WU	The TWG wrote to the relevant agencies in December 2018, directing them to the TWG's analysis and recommendations. Some of these issues are already being considered as part of the review of the Charities Act 2005, or will be considered once the review is complete. Policy decisions from the review are expected to be made later this year and a bill is likely to be introduced in December 2019.	
79	The TWG supports the Government's inclusion of a review of the tax treatment of the charitable sector on its Tax Policy Work Programme, as announced in May 2018.	WU	The Government added a review of charities and non-profit organisations to the Tax Policy Work Programme in 2018 focussing on: • the appropriateness of the tax exemption for significant businesses associated with charities; and • the compliance costs experienced by small charities. The review of significant businesses will take place once the review of the Charities Act 2005 is complete, as that also involves a review of certain business activity. Some simplification measures have been included in a legislative bill currently before Parliament.	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
80-81	The TWG notes the income tax exemption for charitable entities' trading operations was perceived by some submitters to provide an unfair advantage over commercial entities' trading operations. The TWG notes, however, the underlying issue is the extent to which charitable entities are accumulating surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities.	WU	A review of the Charities Act 2005 is currently underway, led by the Department of Internal Affairs on behalf of the Minister for the Community and Voluntary Sector. This will include a review of charities that accumulate funds and charities that operate businesses. A discussion document will be released in late February for consultation until late April 2019.	
82	Consider whether New Zealand should apply a distinction between privately-controlled foundations and other charitable organisations	WP		
83	Consider whether the deregistration tax rules could be amended to more effectively keep assets in the sector, or ensure that there is no deferral benefit through the application of these rules.	WU	Some remedial work on this issue is on the Tax Policy Work Programme and is being progressed. The broader question of whether to keep assets in the sector is best considered as part of the Charities Act 2005 review.	
84	Review whether it is appropriate to treat some not-for-profit organisations as if they were final consumers, or, alternatively, whether it is appropriate to limit the GST concessions to a smaller group of non-profit bodies such as registered charities.	WP		
85	Consider whether the issues identified by the TWG in relation to charities have been fully addressed or whether further action is required, following the conclusion of the review of the Charities Act 2005.	WP		
GST and financial transactions tax				
86	No reduction in the GST rate.	NFW	In responding to the Interim Report, the Government confirmed it is comfortable that no further work is undertaken on GST coverage.	
87	No introduction of exemptions to GST.	NFW		
88	Government monitor international developments in the area of applying GST to financial services.	NFW		
89	No application of GST to explicit fees charged for financial services.	NFW		
90	No financial transactions tax at this point.	NFW	In responding to the Interim Report, the Government confirmed it is comfortable that no further work is undertaken on a financial transactions tax at this time.	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Further info? (✓)
91	The TWG has already reported to Ministers on the issue of GST on low-value imported goods, and the Government recently introduced legislation in December 2018 advancing proposals to address the issue.	WU	The Government introduced legislation in December 2018 to address GST on low-value imported goods.	
Corrective taxes				
92	The TWG supports developing a framework for deciding when to apply corrective taxes.	WP	The TWG wrote to the relevant agencies in December 2018, directing them to the TWG's analysis and recommendations.	
93	Review the rate structure of the alcohol excise with the intention of rationalising and simplifying it.	WP		
94	Prioritise other measures to help people stop smoking before considering further large increases in the tobacco excise rate beyond the increases currently scheduled.	WU		
95	Develop a clearer articulation of the Government's goals regarding sugar consumption and gambling activity.	WP		
Housing				
96	That the Productivity Commission includes vacant land taxes within its review of local government body financing.	WP	The Productivity Commission released an issues paper for this review in November 2018, which does not explicitly provide for consideration of vacant land taxes. This could be brought to the Commission's attention through the submissions process.	
97	That vacant land taxes are best levied at the local rather than the national level.	NFW		
98	Repeal the ten-year rule regarding selling for a gain caused by changes in land use regulation.	WP	Officials support repealing the ten-year rule if capital gains are taxed more broadly. If not, the ten-year rule should be reconsidered in light of its incentive effects on housing supply.	
99	Require disclosure of the purchaser's IRD number on the Land Transfer Tax Statement when purchasing a main home.	WP		

15.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Joint Report: KiwiSaver and the Taxation of Retirement Savings

Date:	18/2/2019	**Report No:**	T2019/297 IR2019/081
		File Number:	SH-13-8-1-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	Indicate whether you require any further advice on the taxation of retirement savings	Monday 25 February
Minister of Revenue (Hon Stuart Nash)	Indicate whether you require any further advice on the taxation of retirement savings	Monday 25 February

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Bevan Lye	Principal Advisor - Tax Strategy	s9(2)(a)	N/A	✓
Mark Vink	Manager - Tax Strategy		N/A	
Phil Whittington	Acting Chief Economist, Inland Revenue		N/A	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Tax Policy Report: Joint Report: KiwiSaver and the Taxation of Retirement Savings

Executive Summary

This report responds to your request for advice and information on four issues:

1. An assessment of the Chamberlain and Littlewood submission

You have requested an assessment of the Chamberlain and Littlewood submission on the merits of tax concessions for saving. In summary, officials are less confident than Chamberlain and Littlewood that current levels of retirement saving are adequate. On the basis of available evidence, however, officials agree with Chamberlain and Littlewood that tax concessions for saving tend to be ineffective, regressive, and distortionary.

There are three main planks to the argument advanced in the submission:

a. **Retirement savings adequacy.** Chamberlain and Littlewood argue there is no evidence to suggest that New Zealanders are generally under-saving for retirement.

   <u>Officials comment</u>: *According to the existing literature, most New Zealanders appear to be saving adequately for retirement. However, this finding rests on the condition that future generations will continue to access New Zealand Superannuation (NZS) under existing policy settings. This condition will not hold if long-term fiscal pressures lead to change to NZS settings. Officials are therefore less confident than Chamberlain and Littlewood that current levels of retirement saving can be said to be adequate.*

b. **The effectiveness of tax concessions.** Chamberlain and Littlewood claim there is little evidence to suggest that tax concessions encourage additional private saving.

   <u>Officials comment</u>: *Officials agree there is little evidence to suggest that tax concessions generate material increases in private saving. Instead, tax concessions tend to encourage a reallocation of existing savings into the tax-preferred vehicle.*

c. **The costs and impacts of tax concessions.** Chamberlain and Littlewood argue that tax concessions are expensive, regressive, and distortionary.

   <u>Officials comment</u>: *Officials agree that untargeted tax concessions for saving will primarily benefit the wealthiest households. Targeted tax concessions will be less regressive, but are also less likely to result in additional private saving. The costs of tax concessions depend heavily on design.*

2. An assessment of removing income tax obligations from KiwiSaver

You have asked for an assessment of the impact of removing income tax obligations from KiwiSaver. Officials have modelled the revenue impact of various options for removing income tax obligations with effect from 1 April 2020.

One important assumption in this modelling is that there would be *no behavioural change* arising from the policy change. This is a constrained assumption that was necessary to simplify the modelling task. In practice, it is likely that there would be a substantial reallocation of savings to take advantage of tax-exempt KiwiSaver accounts.

The following estimates therefore understate – probably substantially – the revenue impacts of the options.[1]

a. **A switch to 'EET' taxation of KiwiSaver.** The first option is to exempt KiwiSaver contributions and earnings, but tax withdrawals. Table 1 sets out the estimated revenue impact of the changes in 2020/21, 2021/22, and 2022/23:

Table 1: Revenue impact of exempting KiwiSaver contributions and earnings

$ million	2020/21	2021/22	2022/23
Exemption of contributions	2,110	2,330	2,580
Exemption of earnings	200	210	220
Taxation of withdrawals	-	-	-
Total	**2,310**	**2,540**	**2,800**

EET taxation would effectively *defer* the taxation of KiwiSaver contributions into the future. It is likely that little tax will be collected from taxing withdrawals in the forecast period. In the very long term, however, the revenue from taxing withdrawals should grow to a similar order of magnitude to the revenue foregone from exempting contributions.

b. **A switch to 'TEE' taxation of KiwiSaver.** A less costly option in the short run would be to tax contributions, but exempt earnings and withdrawals. Based on the estimates outlined in Table 1, this is estimated to cost approximately $200-210 million *per annum* across the forecast period, excluding any behavioural impacts. Officials expect that the behavioural impacts would be significant.

c. **Removing all income tax obligations from KiwiSaver.** If withdrawals also become exempt, then the loss of revenue from exempting contributions and earnings will never be clawed back. Officials are not aware of any other country that exempts retirement saving accounts altogether from taxation. This would be a very regressive change.

The treatment of non-KiwiSaver saving schemes

Extending similar treatment to non-KiwiSaver saving schemes (such as employer schemes, the State Sector Retirement Saving Schemes, and the Government Superannuation Fund schemes) would increase the revenue impacts further. Table 2 illustrates the revenue impact of exempting earnings from all saving schemes:

Table 2: Revenue impact of applying TEE taxation to KiwiSaver <u>and</u> non-KiwiSaver schemes

$ million	2020/21	2021/22	2022/23
Cost of exemption	520	550	570

Table 3 illustrates the revenue impact of removing all income tax obligations from KiwiSaver and non-KiwiSaver saving schemes:

[1] There are some other assumptions and caveats to these estimates. The modelling assumes a fixed growth of income and contributions for all saving schemes. In practice, growth may be different. (In particular, it is possible that KiwiSaver savings grow faster than savings in other schemes, in which case the cost of exempting KiwiSaver will grow faster than forecast.) Also, each of the options are costed on a stand-alone basis; the fiscal cost can differ when different options are packaged together.

Table 3: Revenue impact of removing all income tax obligations from KiwiSaver and non-KiwiSaver saving schemes

$ million	2020/21	2021/22	2022/23
Cost of exemption	3,990	4,240	4,510

Implications for an extension of capital income taxation

Officials estimate that exempting KiwiSaver will reduce forecast revenue from a broad-based extension of capital income taxation (as proposed by the Tax Working Group) by approximately $84 million *per annum*. In the time available, officials have not been able to estimate the impact of exempting non-KiwiSaver saving schemes from an extension of capital income taxation.

3. The Australian retirement income system

You have asked for a brief explanation of the Australian approach to taxing retirement savings. The Australian system is complicated. The following description is taken from publicly-available sources and does not go into the more technical rules.

In Australia, compulsory saving by individuals is intended to supplement or replace a means-tested state pension (the 'Age Pension'). The tax treatment of superannuation is highly concessional, as it is intended to encourage individuals to save more for their retirement – and thereby reduce the fiscal costs of the Age Pension.

Australian superannuation money is taxed in three phases:

- **The contributions phase.** The tax payable on super contributions depends on the type of contribution and the personal circumstances of the taxpayer. Employer and salary contributions are taxed at 15% when they are received by a super fund. Low income taxpayers receive a small refund; high income taxpayers must pay an additional tax.

- **The earnings phase.** Income earned in a super fund is taxed at a maximum rate of 15%. Capital gains on assets held for longer than 12 months within the fund are taxed at 10%. The amount of tax paid by a fund can be reduced by various tax deductions or credits.

- **The payout phase.** When an individual becomes eligible to access their super, they can take a 'super income stream' to provide them with a regular income, or withdraw a lump sum. Super income streams and withdrawals are usually tax-free for individuals aged over 60. Early withdrawals before the age of 60 are allowed in limited circumstances, and are subject to taxation after exceeding a threshold. When a person dies, their super balance is usually paid to their nominated beneficiary. This is called a 'super death benefit.' Some components of the super death benefit are taxable.

The Australian system is expensive and regressive. Much of the value of Australia's superannuation tax concessions flows to high income earners.

There is also an important interaction between superannuation and capital gains taxation in Australia. The concessional treatment of superannuation has created a need for an equally concessional treatment of gains from small businesses, since many entrepreneurs 'save' for their retirement by building up their businesses.

In New Zealand, the absence of generous concessions for retirement saving means there will be less of a case to introduce similar types of small business concessions if there is an extension of capital income taxation.

4. The distributional impacts of the Tax Working Group's proposals for KiwiSaver

The appendix responds to your request for scenarios outlining the distributional impacts of the Tax Working Group's proposals for KiwiSaver.

Recommended Action

We recommend that you:

a **indicate** whether you require any further advice on the taxation of retirement savings.

Yes/no. *Yes/no.*

Mark Vink
Manager, Tax Strategy

Phil Whittington
Acting Chief Economist, Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Tax Policy Report: Joint Report: KiwiSaver and the Taxation of Retirement Savings

Purpose of Report

1. This report responds to your request for advice and information on the following issues:
   - An assessment of the submission on ‘KiwiSaver and tax’ by Michael Chamberlain and Michael Littlewood.
   - An assessment of the impact of removing income tax obligations from KiwiSaver accounts.
   - A description of the Australian approach to taxing retirement saving accounts.
2. The appendix responds to your request for scenarios outlining the distributional impacts of the Tax Working Group’s proposals for KiwiSaver.

An assessment of the Chamberlain and Littlewood submission

3. In October 2018, Chamberlain and Littlewood provided you with a submission on the retirement saving proposals in the Interim Report of the Tax Working Group. In their submission, Chamberlain and Littlewood argue that there is no case to provide tax concessions for saving.
4. Their argument is based on three main propositions:
   - **Retirement savings adequacy** – that there is no evidence to suggest that New Zealanders are generally under-saving for retirement.
   - **The effectiveness of tax concessions** – that it is unclear whether tax concessions actually encourage *additional* saving (rather than simply encouraging the reallocation of existing savings into tax-favoured vehicles).
   - **The costs and impacts of tax concessions** – that tax concessions are expensive, regressive, and distortionary.

Retirement saving adequacy

5. Chamberlain and Littlewood have surveyed a wide range of literature on the saving habits of New Zealanders. The literature indicates that most New Zealanders do appear to be saving adequately for retirement.
6. Moreover, as Chamberlain and Littlewood note, the great majority of older New Zealanders have sufficient income and assets to provide a reasonable standard of living. A small group of older New Zealanders live in material hardship, but the hardship rate for older New Zealanders is lower than for any other age group.[2]

[2] Perry, B. (2018). *Household Incomes in New Zealand: Trends in indicators of inequality and hardship 1982-2017*.

7. These outcomes result from a mix of public income support (mainly through New Zealand Superannuation) and the private savings built up by most of the current cohort over their lifetime.

8. There are, however, some risks to these outcomes. As the Tax Working Group notes, falling rates of homeownership will affect the adequacy of retirement savings.

9. Chamberlain and Littlewood claim that limitations in census data make it impossible to assess whether the home ownership rate is actually falling. However, research published by the Ministry of Social Development indicates that:

   - Cohorts approaching retirement age have declining rates of mortgage-free home ownership.
   - Cohorts approaching retirement age face increasing housing costs as a percentage of income.
   - An increasing proportion of people over the age of 65 live in a home with a mortgage.[3]

10. Taken together, these trends suggest that old age poverty and hardship rates may rise in the future, unless younger cohorts have been able to accumulate substantial assets outside of real estate.[4]

The fiscal sustainability of New Zealand Superannuation

11. The Tax Working Group agrees that most New Zealanders appear to be saving enough for retirement, subject to the condition that future generations remain eligible for New Zealand Superannuation under existing policy settings. The Group cautions that this assumption may not hold if long-term fiscal pressures require change to the scheme.

12. The cost of New Zealand Superannuation is projected to increase substantially over the next fifty years, but Chamberlain and Littlewood believe this path is still fiscally sustainable. They point out that the absolute level of pension expenditure in New Zealand is projected to remain low relative to other OECD countries.

13. Officials disagree with this judgement. The sustained increase in pension expenditure will reduce the Government's ability to manage other calls on its resources. The increase in pension expenditure will also be accompanied by aging-driven increases in other areas of public spending, such as healthcare.[5] It therefore seems unlikely that the existing policy settings for New Zealand Superannuation can be maintained indefinitely into the future.

The effectiveness of tax concessions

14. Chamberlain and Littlewood argue there is little evidence to suggest that tax concessions encourage additional saving by individuals, and that tax concessions generally encourage individuals to reallocate existing savings into the tax-preferred vehicles.

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3 Ibid.

4 There is some evidence to suggest, however, that the average savings rates of each generation have been exceeding those of preceding generations, from the baby boomers onwards. See Vink, M. (2014). *Intergenerational Developments in Household Saving Behaviour*.

5 The Treasury (2016). ***He Tirohanga Mokopuna: 2016 Statement on the Long-Term Fiscal Position.***

15. It is difficult to quantify the impact of tax concessions on saving behaviour, because of the need to make judgements about what would have happened in the absence of the concessions. Nevertheless, the submission from Chamberlain and Littlewood is a fair summary of the literature on this subject.

16. A number of empirical studies have tried to identify a correlation between saving rates and returns to savings in general, and tax incentives for savings in particular. Many of these studies are summarised in the OECD's tax policy study on tax-preferred savings accounts.[6]

17. Despite using a variety of methodologies, most studies have identified only weak correlations between tax incentives and amounts saved. Some studies have found that tax concessions actually reduce rates of private saving.[7]

18. One common finding, however, is that tax concessions tend to generate a significant *reallocation* of existing savings. A New Zealand study based on survey data, for example, found that only one-third of contributions to KiwiSaver accounts represented additional saving; the other two-thirds were reallocated from other saving vehicles.[8] Another New Zealand study, based on administrative data, found that KiwiSaver membership has not been associated with *any* increase in net wealth accumulation.[9]

National saving

19. When thinking about the effectiveness of tax concessions, it is also important to distinguish between *public*, *private*, and *national* saving. Tax concessions may generate some additional private saving, but they will reduce public saving if the cost of the concessions increases the budget deficit. National saving may even fall overall if the reduction in public saving outweighs the increase in private saving.

The costs and impacts of tax concessions

20. Chamberlain and Littlewood argue that tax concessions for saving are regressive, distortionary, and expensive. Officials agree that untargeted concessions are likely to be regressive and expensive. Targeted concessions, on the other hand, will be less regressive – but also less effective at generating increases in private saving.

Distributional impacts

21. At all age levels, higher income households save more than lower income households. The distribution of asset ownership is also very skewed, particularly for financial assets. The top quintile of households by wealth, for example, owns 84% of financial assets in New Zealand.[10]

22. The skewed distribution of household assets arises partly from the fact that individuals are at different points in their lifecycle, but there is still significant inequality in lifetime wealth outcomes between households.[11]

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6 OECD Tax Policy Studies No. 15 *Encouraging Savings through Tax-Preferred Savings Accounts* (2007).

7 This result arises because many individuals save in order to achieve defined saving goals (such as saving up for a first home deposit, or accumulating a certain amount of wealth in order to feel comfortable enough to retire). Tax concessions improve the net return on investments, and therefore reduce the amount that individuals need to put aside in order to achieve their saving goals.

8 Law, D., G. Scobie and L. Meehan (2011). *KiwiSaver: An Initial Evaluation of the Impact on Retirement Saving.*

9 Law, D. and G. Scobie (2014). *KiwiSaver and the Accumulation of Net Wealth.*

10 Statistics New Zealand, *2015 Household Economic Survey.*

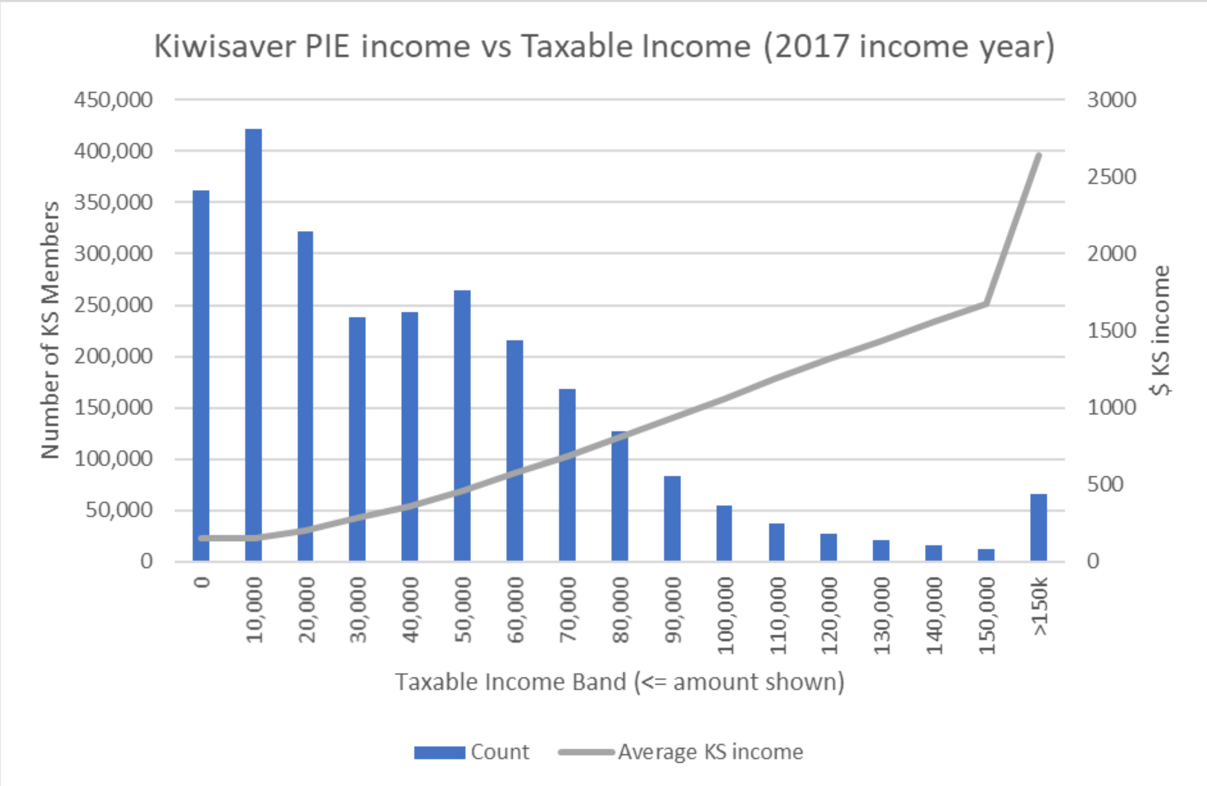
11 Rashbrooke, G., M. Rashbrooke and W. Molano (2017). *Wealth Disparities in New Zealand: Final Report.*

23. This result is reflected in the distribution of KiwiSaver assets. Approximately 2.7 million individuals were enrolled in KiwiSaver in March 2017, earning capital income of $1.3 billion. According to Inland Revenue data, average earnings from KiwiSaver portfolio investment entities (PIEs) increased with taxable income:

- Individuals with taxable income of up to $10,000 per year earned an average of around $150 *per annum* from their KiwiSaver investments.

- Individuals with taxable income between $140,000 and $150,000 earned an average earnings of about $1,700 *per annum* from their KiwiSaver investments.

24. The figure below shows the count of individuals by taxable income and average annual earnings.



Source: Inland Revenue

25. The skewed distribution of asset ownership means that untargeted tax concessions for saving will primarily benefit the wealthiest households. Targeted tax concessions will be less regressive, but are less likely to result in additional private saving for two main reasons:

- Income constraints will prevent some lower income households from increasing their saving rate in response to the concessions, even if they wished to do so.

- Higher income households – who have the greatest capacity to save – will have little incentive to save further because they will derive no marginal tax benefit from additional saving.[12]

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12 This analysis relies on the assumption that tax concessions, if available to higher income households, would generate additional saving. As noted earlier, this assumption is debatable.

Distortions

26. Tax concessions will generate efficiency costs as individuals rearrange their savings to take advantage of tax benefits. These distortions may encourage people to invest in locked-in savings accounts, rather than in more liquid forms of savings or in businesses – even when alternative forms of savings would be preferable in the absence of tax. These types of distortions can reduce productivity if individuals invest in otherwise unproductive investments solely for tax reasons.

27. All else equal, other taxes will need to rise to make up for the loss in revenue from retirement saving accounts. These taxes will generate efficiency costs of their own.

Fiscal impacts

28. The cost of tax concessions varies greatly, and will depend on the details of policy design. By way of illustration, the saving incentives considered by the Tax Working Group had revenue impacts of between $35 million and $2.5 billion *per annum*.

An assessment of removing income tax obligations from KiwiSaver

29. You have asked for an assessment of the impact of removing income tax obligations from KiwiSaver.

A switch to 'EET' taxation of KiwiSaver

30. At the request of the Tax Working Group, the Secretariat modelled the impact of taxing KiwiSaver on an 'EET' basis rather than a 'TTE' basis. This would involve exempting Kiwisaver contributions and earnings, but taxing withdrawals.[13] The modelling assumed that the policy would take effect from 1 April 2020, and that the rules regarding the contribution rates and Member Tax Credit would remain unchanged.[14]

31. The modelling also involved an important assumption that there would be *no behavioural change*. This is a constrained assumption that was necessary to simplify the modelling task. In practice, it is likely that there would be a substantial reallocation of savings to take advantage of tax-exempt KiwiSaver accounts. The estimates therefore understate – probably substantially – the revenue impacts of the change.[15]

32. Table 1 sets out the estimated revenue impact of a switch to EET taxation in 2020/21, 2021/22, and 2022/23:

Table 1: Revenue impact of exempting KiwiSaver contributions and earnings

$ million	2020/21	2021/22	2022/23
Exemption of contributions	2,110	2,330	2,580
Exemption of earnings	200	210	220
Taxation of withdrawals	-	-	-
Total	**2,310**	**2,540**	**2,800**

13 'TTE' ('taxed – taxed – exempt') means that contributions and earnings will be taxed, but withdrawals are exempt. 'EET' ('exempt – exempt – taxed') means that contributions and earnings are exempt, but withdrawals will be taxed.

14 Repeal of the Member Tax Credit would reduce the fiscal cost of the change, but it would also be a regressive measure.

15 There are some other assumptions and caveats to these estimates. The modelling assumes a fixed growth of income and contributions for all saving schemes. In practice, growth may be different. (In particular, it is possible that KiwiSaver savings grow faster than savings in other schemes, in which case the cost of exempting KiwiSaver will grow faster than forecast.) Also, each of the options are costed on a stand-alone basis; the fiscal cost can differ when different options are packaged together.

33. EET taxation would effectively *defer* the taxation of KiwiSaver contributions into the future. It is likely that little tax will be collected from taxing withdrawals in the forecast period.[16] In the very long term, however, the revenue from taxing withdrawals should grow to a similar order of magnitude to the revenue foregone from exempting contributions.

34. EET taxation would be administratively complex. Existing retirement accounts would need to be grandparented, in order to avoid triple taxation on a 'TTT' basis.

A switch to 'TEE' taxation of KiwiSaver

35. A less costly option in the short run would be to tax contributions, but exempt earnings and withdrawals (TEE taxation). Based on the estimates outlined in Table 1, this is estimated to cost approximately $200-210 million *per annum* across the forecast period, excluding any behavioural impacts. Officials expect that the behavioural impacts would be significant.

Removing all income tax obligations from KiwiSaver

36. If withdrawals also become exempt – i.e. an 'EEE' approach to KiwiSaver – then the loss of revenue from exempting contributions would never be clawed back. Officials are not aware of any other country that exempts retirement saving accounts altogether from taxation. This would be a very regressive change.

The treatment of non-KiwiSaver saving schemes

37. KiwiSaver is not the only saving scheme available to New Zealanders. Many New Zealanders are members of other private or occupational saving schemes (such as employer schemes, the State Sector Retirement Savings Scheme, and the Government Superannuation Fund schemes).

38. There is no obvious reason to exclude similar types of saving schemes from any favourable treatment extended to KiwiSaver. Extending similar treatment to non-KiwiSaver schemes would, however, generate substantial revenue costs.

39. Table 2 illustrates the revenue impact of exempting earnings associated with both KiwiSaver and non-KiwiSaver saving schemes:

Table 2: Revenue impact of applying TEE taxation to KiwiSaver <u>and</u> non-KiwiSaver schemes

$ million	2020/21	2021/22	2022/23
Cost of exemption	520	550	570

40. Table 3 illustrates the revenue impact of removing all income tax obligations from KiwiSaver and non-KiwiSaver saving schemes:

Table 3: Revenue impact of removing all income tax obligations from KiwiSaver <u>and</u> non-KiwiSaver saving schemes

$ million	2020/21	2021/22	2022/23
Cost of exemption	3,990	4,240	4,510

16 This reflects an assumption that the tax on withdrawals will only apply to withdrawals of savings and returns made after 1 April 2020. Most people retiring in the forecast period will likely prefer to withdraw their TTE savings before their EET savings.

41. As with the previous estimates, these estimates do not account for any behavioural responses arising from the policy change. As a result, they will also understate substantially the revenue impacts of the change.

Implications for an extension of capital income taxation

42. Decisions on the tax treatment of KiwiSaver will affect the revenue generated by any extension of capital income taxation. Officials estimate that exempting KiwiSaver will reduce the forecast revenue from a broad-based capital gains tax (as proposed by the Tax Working Group) by approximately $84 million *per annum*.

43. In the time available, officials have not been able to estimate the impact of exempting non-KiwiSaver saving schemes from an extension of capital income taxation.

The Australian retirement income system

44. You have asked for a brief explanation of the Australian approach to taxing retirement savings. The Australian system is complicated. The following description is taken from publicly-available sources and does not go into the more technical rules.

45. As context, the Australian retirement income system has four pillars:

- The means-tested **Age Pension**, provided by the Government, which guarantees a minimum 'safety net' level of income in retirement.
- Compulsory saving through the **Superannuation Guarantee**, which is currently set at 9.5 per cent of wages.
- **Voluntary superannuation savings**, including voluntary pre-tax and post-tax super contributions.
- **Other voluntary savings**, such as housing, other property, and other financial assets.

46. Compulsory saving through the Superannuation Guarantee is intended to supplement or replace the Age Pension. The tax treatment of superannuation is therefore highly concessional, as it is intended to encourage individuals to save more for their retirement – and reduce the fiscal costs of the Age Pension.

The tax treatment of Australian superannuation

47. Australian superannuation money is taxed in three phases: when it goes into a superannuation fund (the contributions phase); while it is in the fund (the earnings phase); and when it leaves the fund (the payout phase).

The contributions phase

48. The amount of tax payable on super contributions depends on the type of contribution and the personal circumstances of the taxpayer.

49. Employer and salary sacrificed super contributions are taxed at 15% when they are received by a super fund.

50. If an individual earns $A37,000 or less, tax paid on super contributions (up to $A500) will be automatically added back into the individual's super account through the 'low income super tax offset.'

51. If an individual's combined income and super contributions exceed $A250,000, the individual will pay 'Division 293' tax. This is an additional 15% tax on the lesser of the taxpayer's concessional contributions or the amount in excess of $A250,000.

52. Additional after-tax personal contributions, and those received under the government's co-contribution scheme, are not taxed when they are put into a super fund.

The earnings phase

53. Income earned in a super fund is taxed at a maximum rate of 15%. Capital gains on assets held for longer than 12 months within the fund will be taxed at 10%.

54. The amount of tax paid by a fund can be reduced by tax deductions or tax credits. For example, a growth fund may only pay an average of 7% tax because its dividend income entitles it to dividend imputation credits.

The payout phase

55. When an individual becomes eligible to access their super, they can take a super income stream to provide them with a regular income, or withdraw all or part of their benefit as a lump sum.

56. Super income streams and withdrawals are usually tax-free for individuals aged over 60. Early withdrawals before the age of 60 are allowed in limited circumstances, and are subject to taxation after exceeding a threshold.

57. When a person dies, their super balance is usually paid to their nominated beneficiary. This is called a 'super death benefit.' Some components of the super death benefit are taxable.

Reflections on the Australian system

Distributional impacts

58. Superannuation provides much larger tax concessions per person to high-income earners. In 2015, over half of the value of superannuation tax breaks – for earnings and contributions combined – flowed to the top 20% of income earners.[17]

Fiscal impacts

59. The fiscal impact of the Australian system is substantial. The cost of superannuation tax concessions was $A42.3 billion in 2017/18. This was 20% of personal income tax collections, which raised $A211.4 billion in that year. The cost of superannuation tax concessions is projected to rise to $A58.8 billion in 2020/21.[18]

60. By way of comparison, the cost of the KiwiSaver tax credit was $830 million in 2017/18. This is 0.3% of New Zealand's source deductions (mainly PAYE on wages and salaries), which raised $30.7 billion in 2017/18.

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17 Daley, G., B. Coates and D. Wood (2015). *Super tax targeting*.

18 All revenue estimates are sourced from the Australian Treasury.

61. Superannuation tax concessions are unlikely to be a cost-effective means to reduce the future Age Pension liabilities of the Australian Government. Australian Treasury projections from 2012, for example, show that the lifetime value of tax breaks to high-income men is actually much higher than the value of the Age Pension for low-income earners.[19]

s9(2)(g)(i)

[redacted]

Implications for an extension of capital income taxation

65. There is an important interaction between superannuation and capital gains taxation in Australia. The concessional treatment of superannuation has created a need for an equally concessional treatment of gains from small businesses.[20]

66. This is because the primary way in which many entrepreneurs 'save' for their retirement is by starting and growing their business. Taxing these businesses on a non-concessional basis would favour passive retirement saving over entrepreneurial activity, with broader impacts for growth and productivity.

67. In New Zealand, the absence of generous concessions for retirement saving means there will be less of a case to introduce similar types of small business concessions if there is an extension of capital income taxation.

Next steps

68. Officials are ready to provide further advice at your request on the tax treatment of KiwiSaver and other forms of retirement savings.

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19 Australian Treasury (2012). *Distributional analysis of superannuation tax concessions: a paper to the Superannuation Roundtable*.

20 One of the most important concessions for small business is that capital gains from the sale of active assets are exempt up to a lifetime limit of $A500,000.

Appendix: The distributional impacts of the Tax Working Group's proposals for KiwiSaver

On 13 February 2019, you asked officials to provide scenarios outlining the distributional impacts of the Tax Working Group's proposals for KiwiSaver.

Aggregate impacts

Table 1 shows the aggregate cost or gain accruing to all KiwiSaver members across different income bands:

Table 1: Aggregate impacts

$million	Aggregate (cost) / gain across all KiwiSaver members earning…		
	$0-48,000	**$48,000-70,000**	**$70,000+**
Additional tax on KiwiSaver funds from an extension of capital income taxation	**(19.0)**	**(19.0)**	**(46.0)**
a. Refund ESCT for KiwiSavers earning up to $48,000 *per annum*	180.0	96.0	-
b. Offer maximum member tax credit to KiwiSavers on parental leave, regardless of contributions	7.0	2.0	3.0
c. Increase member tax credit from $0.50 for every $1 of contribution to $0.75	227.0	130.0	133.0
d. Reduce the lower PIE rates for KiwiSaver funds by five percentage points each.	70.0	24.0	-

Individual scenarios

Table 2 shows stylised scenarios for savers with three income levels ($48,000 *per annum*, $100,000 *per annum*, and $200,000 *per annum*).

The assumptions are:

- Each saver saves 3% of their pre-tax income into KiwiSaver.
- There is a matching employer contribution, which is subject to employer superannuation contribution tax (except for the ESCT exemption option).
- Status quo PIE and KiwiSaver rules apply, except as varied in the scenarios.
- Every year the balance earns a 5% pre-tax return.

These scenarios are heavily driven by the assumptions, and should be treated with caution.

The savings accumulated under policy options a, c, & d do not add up to the estimated total for all three implementation options. This due to the interplay between the different design considerations.

Table 2: Saving accumulations under different policy options

	Savings accumulated after thirty years for an individual within income of…		
Policy option	**$48,000**	**$100,000**	**$200,000**
Status quo policy settings	$186,553	$299,735	$572,128
a. Refund ESCT for KiwiSavers earning up to $48,000 *per annum*[21]	$201,581	$299,735	$572,128
b. Offer maximum member tax credit to KiwiSavers on parental leave, regardless of contributions	*Difficult to estimate*	*Difficult to estimate*	*Difficult to estimate*
c. Increase member tax credit from $0.50 to $0.75 for every $1 of contribution	$201,472	$313,407	$585,800
d. Reduce the lower PIE rates for KiwiSaver funds by five percentage points each.	$194,960	$299,735	$572,128
Implement options a, c and d	$226,230	$313,407	$585,800

Table 3 shows the dollar increase in savings accumulated under each of the options, relative to status quo policy settings.

As above, the savings accumulated under policy options a, c, & d do not add up to the estimated total for all three implementation options. This due to the interplay between the different design considerations.

Table 3: Dollar increase in savings accumulations relative to status quo policy settings

	Increase in savings accumulated after thirty years for an individual within income of…		
Policy option	**$48,000**	**$100,000**	**$200,000**
a. Refund ESCT for KiwiSavers earning up to $48,000 *per annum*	$15,027	-	-
b. Offer maximum member tax credit to KiwiSavers on parental leave, regardless of contributions	*Difficult to estimate*	*Difficult to estimate*	*Difficult to estimate*
c. Increase member tax credit from $0.50 to $0.75 for every $1 of contribution	$14,919	$13,671	$13,671
d. Reduce the lower PIE rates for KiwiSaver funds by five percentage points each.	$8,407	-	-
Implement options a, c and d	$39,677	$13,671	$13,671

21 The Tax Working Group noted that the refund could be clawed back for KiwiSavers earning over $48,000. Abating the ESCT refund for higher income individuals would not affect the outcomes for the savers in these scenarios.

Table 4 shows the percentage increase in savings accumulated under each of the options, relative to status quo policy settings.

Table 4: Percentage increase in savings accumulations relative to status quo policy settings

	Increase in savings accumulated after thirty years for an individual within income of…		
Policy option	**$48,000**	**$100,000**	**$200,000**
a. Refund ESCT for KiwiSavers earning up to $48,000 *per annum*	8%	-	-
b. Offer maximum member tax credit to KiwiSavers on parental leave, regardless of contributions	*Difficult to estimate*	*Difficult to estimate*	*Difficult to estimate*
c. Increase member tax credit from $0.50 to $0.75 for every $1 of contribution	8%	5%	2%
d. Reduce the lower PIE rates for KiwiSaver funds by five percentage points each.	5%	-	-
Implement options a, c and d	21%	5%	2%

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

Briefing note

Reference: BN2019/095

Date: 20 February 2019

To: Tax Advisor, Minister of Finance – Kieran Kennedy
Revenue Advisor, Minister of Revenue – Paul Quirke
Private Secretary, Minister of Revenue – Larissa Anderson

cc: Naomi Ferguson, Commissioner
Cath Atkins, Deputy Commissioner
Matt Benge, Chief Economist
Emma Grigg, Policy Director
David Carrigan, Policy Director
s9(2)(a)
Government & Executive Services (Ministerial Services)
Policy records management (PAS RM)

From: Phil Whittington, Senior Policy Advisor, Inland Revenue

Subject: **High-level comparisons of Australia and New Zealand tax system**

Purpose

1. This note responds to your request to compare the New Zealand and Australian tax systems along a number of dimensions, particularly in light of the Tax Working Group's recommendations for extending the taxation of capital gains.

2. For simplicity we have not modelled or commented on the Australian or New Zealand welfare and transfer system or its interactions with the tax system. In the context of taxes on those who are earning capital gains, the welfare and transfer systems are less likely to be relevant given capital gains tend to be earned by those on higher incomes.

3. Because of the scale and importance of the tax concessions in the Australian superannuation system, these are commented on and modelled in the discussion below. Kiwisaver tax concessions have also been modelled.

4. In general, the examples show that for high labour income earners, taxes are likely to be higher in Australia. For those with very high capital gains, or retirees, taxes are likely to be higher in New Zealand under the Tax Working Group proposals.

Main features of the New Zealand and Australian systems

5. Australia has a tax to GDP ratio of 27.8%, while New Zealand's is 32%. These figures include state-level payroll taxes and stamp duties in Australia, and local body taxation in New Zealand.

6. Aside from the current non-taxation of most capital gains, New Zealand's tax system taxes income at much more even rates, regardless of how it is earned. There is a modest 5 percentage point difference between the top personal rate and the PIE and company rate.

7. New Zealand's top tax rate (33%, or 34.39% with the ACC earner's levy) is also significantly lower than Australia's top tax rate (45%, or 47% with the Medicare levy).

8. In contrast, in Australia income is taxed very differently depending on how it is earned. There is a 17 percentage point difference between the top personal rate and the company rate (30%), although when dividends are paid, the income is taxed at the personal rate with credits for tax at the company level (as in New Zealand). However, the deferral benefit for earning income in a company in Australia is significantly greater than in New Zealand.

9. More significantly, for those in the payout phase (over the age of 60), the tax rate on income in an Australian super fund is 0%. Thus, for high income people, the differential treatment of how income is taxed can be very large: either 47% if earned personally, or 0% if put in a super fund.

10. As previously explained (T2019/297, IR2019/081 refers), the very low taxation of retirement savings in Australia influences the treatment of capital gains in a small business, which are often used to fund retirement. The non-taxation of income of high income earners has obvious fairness implications, but also efficiency implications. By requiring income to be in a locked in superfund, and noting the relatively high fees charged on these superfunds (see for example the Australian Productivity Commission's conclusion that "Evidence abounds of excessive and unwarranted fees in the super system"[1]), the Australian system indirectly subsidises the financial industry.

11. By providing very concessionary retirement concessions, the Government has to have higher taxes on other income to fund these concessions.

12. If the concern is that taxing capital gains on retirement will cause people to move to Australia, we note that the current exemption for capital gains means that, for any given level of revenue, we must have higher taxes on other forms of income. Those higher taxes must have their own incentive effects that will (to a greater or lesser extent) discourage people from moving to New Zealand or encourage them to move offshore.

13. Further, those New Zealanders moving to Australia for retirement will lose eligibility for NZ Superannuation payments if their assets are above the Australian means tested threshold for the Australian Aged Pension. This is likely to be the case if they are moving due to concerns about paying a large capital gains tax obligation. Finally, if the small business is in New Zealand, the TWG proposals would mean that the gain in the value of the business is taxed on emigration in any event.

14. Looking at the personal income tax (including the Medicare levy in Australia and the ACC earners levy in New Zealand), New Zealand has a much flatter structure than

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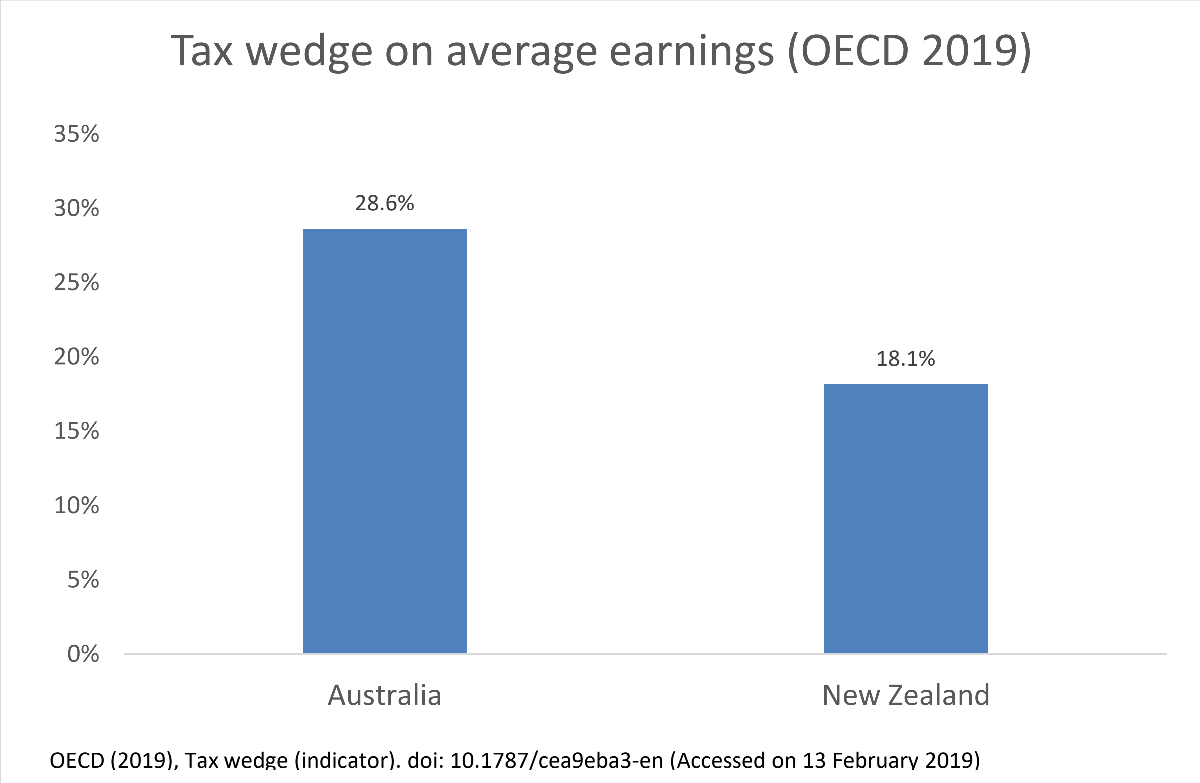
[1] Australian Productivity Commission, *Superannuation: Assessing Efficiency and Competitiveness, Overview*, 21 December 2018, p 2. https://www.pc.gov.au/inquiries/completed/superannuation/assessment/report/superannuation-assessment-overview.pdf

Australia. The following chart shows the average tax rate on different levels of earnings.

15. Another way of looking at the tax on personal income is with the OECD's tax wedge measure. The tax wedge is defined as the ratio between the amount of taxes paid by an average single worker (a single person at 100% of average earnings) without children and the corresponding total labour cost for the employer[2]. The average tax wedge measures the extent to which tax on labour income discourages employment. This indicator is measured in percentage of labour cost.

[2] The tax wedge is the sum of personal income tax, employee plus employer social security contributions together with any payroll tax, minus benefits as a percentage of labour costs.



16. Australia's tax wedge is materially higher than New Zealand's because Australia's average incomes are higher (resulting in an average tax rate that is higher due to the progressive Australian tax schedule), and Australia also has state-level payroll taxes which add to the tax wedge.

Specific examples

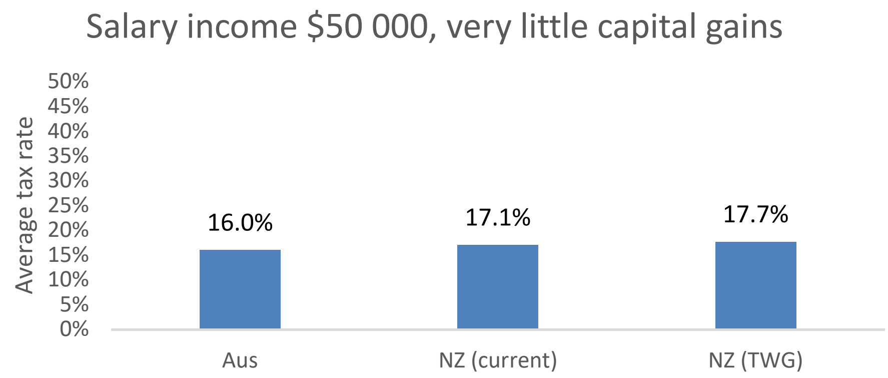
17. In the following examples, the dollar figures quoted are New Zealand dollars, but for modelling Australian results they have been converted to Australian dollars[3]. We have not modelled any transfer or welfare payments (e.g Working for Families Tax Credits or any Australian equivalents), or any state payroll taxes in Australia. This is for three reasons:

- Transfer and welfare payments are likely to be less important for those who make capital gains (as their incomes tend to be higher), and it requires further assumptions about family situations.
- State payroll taxes in Australia vary by state.
- It would be difficult to establish whether we had correctly modelled the Australian transfer payment systems as we do not have access to experts in the Australian transfer payment system.

18. In all of these examples, the capital gains are the gains realised during that year.

[3] As an example, in the first scenario the $50 000 NZD ordinary earnings is modelled in the Australian system as $48 123 AUD, using an exchange rate of $1 AUD for $1.039 NZD (as at 15 February 2019)

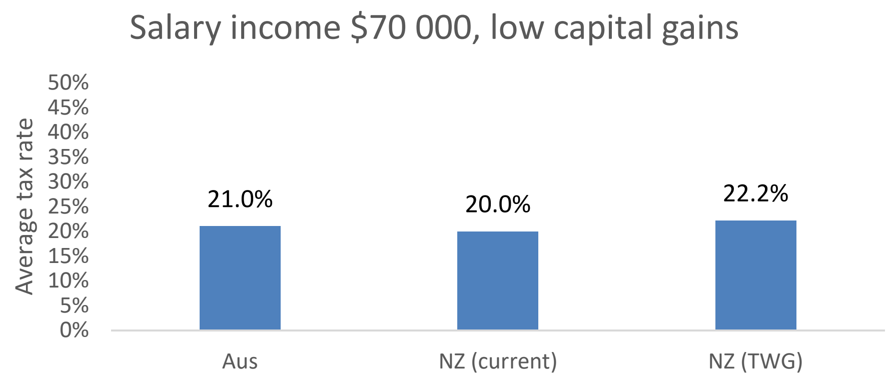
Example 1: Salary income $50 000, very little capital gains



Ordinary earnings:	$50 000
Cap gains:	$1 000
Total income	**$50 000**

19. In this example there would be a 0.6 percentage point increase in the average tax rate for the income in New Zealand. Because of Australia's tax-free threshold, the average tax rate in New Zealand is currently slightly higher than it would be in Australia with the same income.

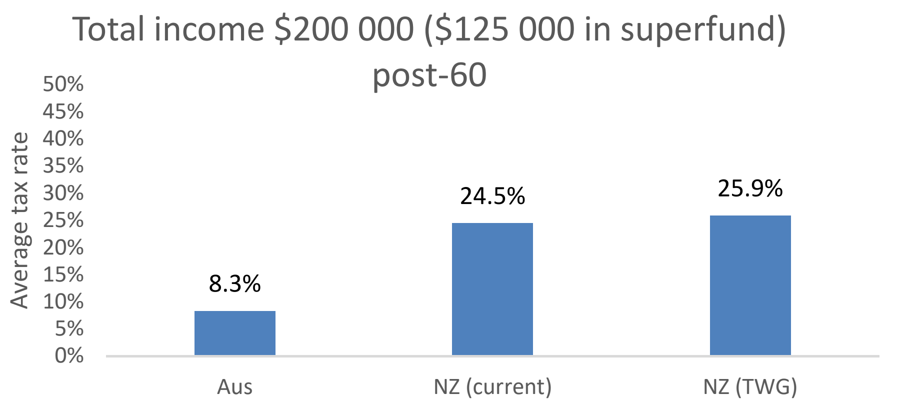
Example 2: Salary income $70 000, low capital gains



Ordinary earnings:	$70 000
Cap gains:	$5 000
Total income	**$75 000**

20. In this example the person would be taxed slightly less in New Zealand than in Australia currently, but this would increase by 2.2 percentage points if capital gains were taxed, bringing it slightly higher than in Australia.

Example 3: Total income of $200 000, with $125 000 income from a superfund, after age 60

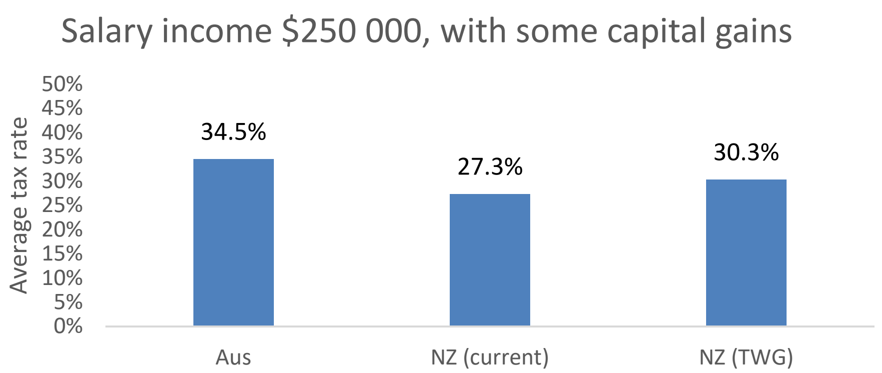


Ordinary earnings:	$75 000
Interest and dividends (in a super fund)	$115 000
Cap gains (in a superfund)	$10 000
Total income	**$200 000**

21. In this example we can see the scale of Australia's retirement tax concessions. Despite having a significantly higher income than any of the previous examples (including ordinary earnings that are higher than any of the previous examples and still taxed at ordinary rates), the Australian average tax rate is the lowest of any effective tax rate yet. This is because $125 000 of income is untaxed in Australia as it is in a superfund in the payout phase. If the ordinary earnings (of $75 000) were passive earnings and were able to be earned through a superfund, the average tax rate in Australia would be 0%.

22. The New Zealand effective tax rate is 24.5%, rising to 25.9% if the $10 000 of capital gains are taxed at the Kiwisaver PIE rate of 28%.

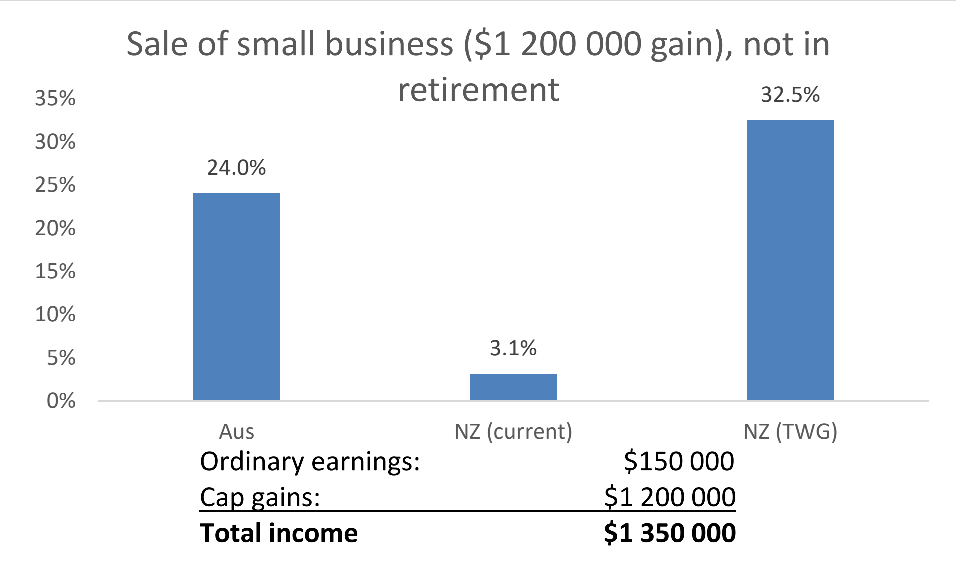
Example 4: Salary income $250 000, with some capital gains



Ordinary earnings:	$250 000
Cap gains:	$25 000
Total income	**$275 000**

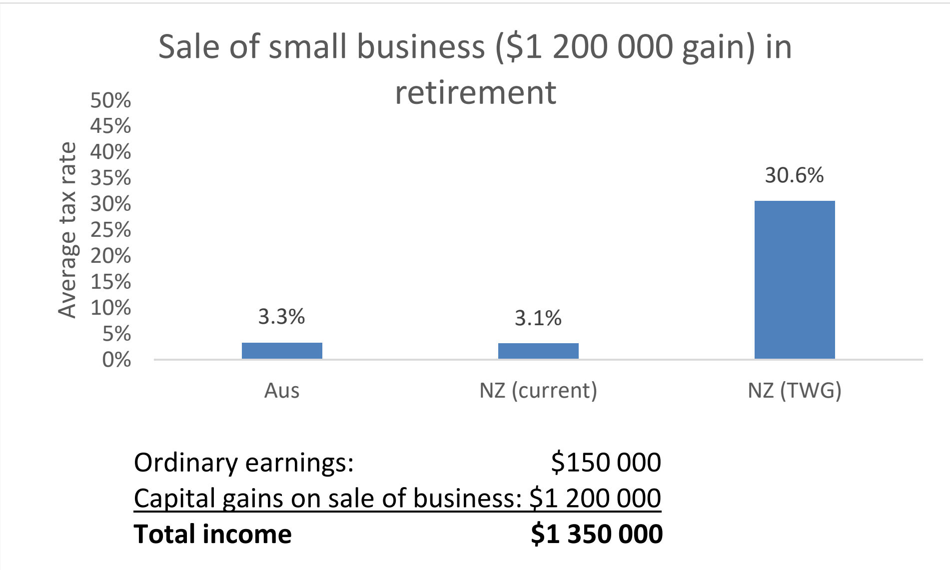
23. In this example, despite the 50% discount received in Australia, the average tax rate on all the person's income would still be lower in New Zealand under the Tax Working Group's proposal than in Australia.

Example 5: Sale of a small business, no retirement concessions available



24. This example looks at the effective tax rate if none of the Australian retirement concessions are available (but it does allow the 50% capital gains tax discount in Australia). This would be the case if the person was aged under 55 and not permanently incapacitated. In this case, the average tax rate in Australia is 24%. In New Zealand currently it is 3.1% due to the exemption of capital gains from taxation. Under the Tax Working Group proposal that effective tax rate would rise to 32.5%.

Example 6: Sale of small business ($1 200 000 gain) in retirement



25. The Australian retirement concessions and New Zealand's current exemption of capital gains result in very low average tax rates – lower than any other example, despite total income being the highest equal (with example 5). The Tax Working Group proposals would significantly increase the average tax rate on this substantial amount of income.

Phil Whittington
Senior Policy Advisor

s9(2)(a)

Country	Tax/GDP[4]	Top personal rate	Top personal threshold	Other labour taxes	Capital gains discount	Small business CGT concessions	Company rate
Australia	27.8%	45% (47% with Medicare Levy)	$180 000	State payroll taxes: NSW: 5.45% Victoria: 3.65% - 4.85% Queensland: 4.75% SA: 2.5% - 4.95% WA: 5.5% Tasmania: 6.1% ACT: 6.85% NT: 5.5%	50% inclusion rate for individuals (i.e. 50% of the capital gain is taxed at person's marginal rate). No discount for general companies. See small business CGT concessions for discount for small businesses.	4 types of small business concession: Exemption if owner is aged over 55 and has owned asset for at least 15 years and is retiring. Exemption if funds put into the owner's super scheme ($500k AUD lifetime cap) 50% discount for small business assets owned for 1 year (can be combined with individual discount so taxed on only 25% of gain) Rollover for small businesses that reinvest in active assets within two years.	30%. 27.5% for small businesses
NZ	32.0%	33% (34.39% with ACC earner's levy)	$70 000		No tax at all currently. No discount under TWG proposal.	No CGT currently. TWG propose retirement concession: lower Kiwisaver tax rates apply to the first $500,000 of capital ains made by business owners who sell a closely held active business they have owned for a certain period of time (e.g. 15 years) in order to retire once they reach retirement age (e.g. 60 years or older) or younger business owners if the capital gain is reinvested into a Kiwisaver scheme. TWG propose rollover for small businesses (less than $5m of turnover) that reinvest in active assets.	28%

[4] Source: *OECD Revenue Statistics*, https://stats.oecd.org/index.aspx?DataSetCode=REV, accessed 20 February 2019.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Options for extension of tax on capital gains

Date:	22 February 2019	**Priority:**	High
Security level:	Sensitive - Budget	**Report number:**	IR2019/085 T2019/403

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	25 February 2019
Minister of Revenue	**Note** the contents of this report	25 February 2019

Contact for telephone discussion (if required)

Name	Position	Telephone	
Mark Vink	Manager, the Treasury	s9(2)(a) [redacted]	
Emma Grigg	Policy Director		
Casey Plunket	Special Policy Advisor, Inland Revenue		

22 February 2019

Minister of Finance
Minister of Revenue

Options for extension of tax on capital gains

Executive summary

Purpose

1. Officials earlier reported on the pros and cons of the Tax Working Group minority view (taxing gains on residential rental property and second homes only) and the majority view (a comprehensive extension of taxing capital gains on all business and investment property) (*Major Design Issues in the Taxation of Capital Gains* (IR 2019/061, T2019/246). This report provides advice on another partial extension, of taxing the sale of land used in business as well as residential property. Like the residential-only extension, this extension would apply to capital gains from the sale of buildings and other improvements, as well as the unimproved land on which they sit.

Background

2. The earlier report concluded that:

   - A broad extension of tax on capital gains as recommended by the TWG majority, coupled with complementary changes to improve efficiency and productivity, would advance the Government's objectives for the tax system more than the narrower extension to non-owner occupied residential property recommended by the minority (paragraph 8)

   - An extension limited to all non-owner occupied residential property would nevertheless be an improvement over the current system (paragraph 9) and technically feasible (paragraph 81), as well as being the most feasible first phase if a phased-in implementation were desirable (paragraph 15). The Report also provided a table comparing the effect of such an extension with the effect of a broad extension

   - An extension to all non-owner occupied land and buildings (that is, the extension considered in more detail in this report) would be more problematic technically and have increased compliance costs (paragraph 81). It might also be difficult to implement in a reasonable timeframe.

Extension to all land

3. An extension of tax to capital gains on all non-owner occupied land is estimated to raise $4.3 billion over 5 years, as opposed to $2.3 billion for all non-owner occupied residential land. This is a static costing and does not take into account any behavioural impacts that could occur for example through people deferring the tax by investing in land through land-owning companies.[1] It is unusual internationally to tax capital gains on land without having a wider tax on gains on business and investment assets.[2]

[1] This report discusses the need to have taxation of the sale of land-rich companies, but even if the regime had this, there would still be cases of companies owning land that do not meet the definition. These could be sold without any tax impost, and might therefore be a preferred vehicle for land investment.
[2] We are aware of only two countries that do this, Cyprus and Malaysia.

4. From a practical and design perspective, an extension to all land raises some significant additional issues to those raised by an extension only to residential land. In particular it:

- imposes tax on one class of business asset and not others, which is not horizontally equitable. Farmers and Maori collectives, who are heavily invested in land would be very much affected, whereas digital services companies (for example) would be unaffected

- expands considerably the range of transactions where tax will have to be determined on an asset valuation basis (rather than simply by reference to the amount paid in an arm's length transaction). Any sale of a land-owning business is likely to require an allocation of the global price between land (taxable) and goodwill (generally exempt). This will be an on-going issue, which would not usually arise if tax is imposed only on a sale of residential property (except for the one-off requirement for valuations on valuation day)

- creates a need to consider the possible introduction of roll-overs or concessions into the law, for example where business land is sold and replacement land acquired by a small business. These are the same kind of roll-overs that would also be considered in the case of a comprehensive extension

- expands the range of transactions where tax may have to be imposed on a sale of shares in a land rich company. A rule to tax the sale of shares in land rich companies has the potential to cause considerable complexity This is true whether the extension is limited to residential land or applies to all land, but will be much less widespread in a more limited extension. There are a number of choices in the design of such a rule, and these are considered in some detail in this Report. Land rich company rules would not be required in the case of a comprehensive extension (except for non-resident owners of companies holding New Zealand land)

- may be a higher compliance cost first step in a phased approach (than a residential only first step) because it will require businesses to undertake valuations on two valuation dates – first for business land, and later for all other business capital assets.

5. Maori own significant amounts of land collectively, such as Maori freehold land and through post-settlement governance entities. Officials will report to you in early March 2019 on how either a comprehensive or "all land" extension would apply to Maori collectively-owned assets, informed by an inter-agency process

6. Other partial extensions are technically feasible. For example, taxing listed shares is possible without much additional complexity, but if it does not include taxing unlisted shares, that would impose a tax penalty for listing which could adversely impact how companies and investors raise capital and the efficiency of capital markets.

Summary

7. The following table summarises the features and differences of the different extension options. More information is provided in the table in the main section.

	Residential land only	All land	Comprehensive
Revenue over 5 years	$2.3 billion	$4.3 billion	$8.2 billion
Types of businesses and taxpayers affected	Residential property investors and owners of baches and other second homes	As for residential land plus non-residential land investors plus all land owning businesses	Most taxpayers who own business or investment assets.
Complexity	Much smaller increase in compliance costs Less need for roll-overs. Increases compliance costs for residential landlords or landlords plus those with second homes. Valuations of existing assets less complex than other business assets and private shares Defining residential land rich companies, and taxing gains/losses, complex	Increases compliance costs for any taxpayer with land or shares in a land rich company Valuation issues less complex than for comprehensive but more complex than for residential only Defining land rich companies, and taxing gains/losses complex Increased pressure for roll overs.	Increases compliance costs for all taxpayers earning capital gains Valuations of existing assets when tax comes into effect complex especially for business assets and private shares Complex adjustment for shares of members of corporate groups Most pressure for roll overs No need to define land rich companies, except for purpose of taxing non-resident shareholders.
Efficiency and productivity	Least (minimal effects on efficiency and productivity)	Limited negative effects on efficiency and productivity (but greater potential for efficiency enhancing offsets)	More negative effects on efficiency and productivity (but greatest potential for efficiency improving offsets)
Integrity	Little effect on integrity outside of labour component of rental residential housing appreciation. Will replace existing bright line rule, thus eliminating the boundary between land held for shorter and longer periods. Need for rules for residential land rich companies, which will be complex and will create boundary issues	Will improve taxation of labour component of all land appreciation (eg farms as well as residential housing) Will replace existing complex rules taxing some sales of land. Need for rules for land-rich companies, which will be complex and will create boundary issues.	Reduces scope for companies to be used to shelter income from higher rates of personal tax Stops conversion of income into capital gains Reinforces fairness and sustainability gains

8. Having considered the issues further, officials are more comfortable with the possibility of an extension to all non-owner occupied land than previously, but:

   - do not consider it to be as effective a comprehensive extension in advancing the Government's objectives (particularly integrity), though this depends in part on how the revenue raised is used;
   - do not believe it is preferable to a residential only extension if the intention is a phased approach to a comprehensive extension.

Next steps

9. As previously signalled, officials plan on providing you in the week commencing 25 February with a report highlighting areas of capital gains design details where we are likely to recommend either:

   - the Government consult on an alternative approach to that suggested by the TWG majority view; or
   - where we are likely to suggest a slight variation to a TWG recommendation.

   This report will be for information purposes, similar to the recent report we provided on the "non-capital gains" recommendations of the Group.

10. There are some issues that officials are still considering in further detail, primarily the approach to Maori collectively-owned assets and the possible tax treatment of shares held in offshore companies. These issues will be covered in reports scheduled for early March.

11. Given the Government commitment to make announcements in April (and the extended recess over Easter and ANZAC day in late April), we consider that decisions on the form and content of any public consultation will need to be made by Ministers in mid-March so that a Cabinet paper can be drafted and considered by coalition partners.

Recommended action

We recommend that you discuss the contents of this report with officials, with the aim of deciding which option should be progressed by mid-March.

Noted — Noted

s9(2)(k)

Mark Vink
Manager, Tax Strategy
The Treasury

Casey Plunket
Special Policy Advisor
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Options for extension of tax on capital gains

Purpose

1. This Report follows a meeting between Ministers and officials in which you expressed interest in an option of taxing all property gains other than on owner-occupied property. This report discusses economic and technical design issues with that approach.

2. Ministers are invited to indicate what further information they require, in order to determine what proposal the Government wishes to consult on. This decision will be critical to [the content of the Government discussion document on the extension of tax on capital gains, which needs to be released by the end of May in order to meet the Government's intention to have legislation on capital gains enacted before the 2020 election.

Summary table

3. In our previous report, we included a table comparing the majority and minority recommendations. The following table supplements that by also summarising the all-land option analysed in this report.

Table 1: Comparison of comprehensive versus limited extensions of capital gains

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Revenue over 5 years[4]	$8.2 billion	$2.3 billion[5]	$4.3 billion
Impact on packages	• Provides significant funds for balancing initiatives in package; • Could fund productivity measures and/or fairness measures • If impact on business is a key concern, $4.0 to $5.3 billion for fairness measures after business package.	• If impact on business is a key concern, less need for business package (although business package desirable on own account) • Funds could be directed at fairness measures	• If impact on business is a key concern, greater need for business package. • Funds could be directed at fairness measures
Progressivity	• Substantial increase in progressivity • Financial assets concentrated in upper income percentiles • Taxing financial and business assets targets increased taxation to upper income earners	• Smaller progressivity benefit • Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed	• Larger progressivity benefit than residential land only, but still much smaller than comprehensive

[4] These revenue estimates are preliminary and indicative and may change following receiving further information or quality assurance. The costing is in tax years and will be different once converted into fiscal years.

[5] Of which about $0.4 billion comes from taxing second homes.

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Horizontal equity	• Greater improvement • More closely aligns capital income taxation to taxation of other income	• Modest improvement • Evens out taxation of residential real estate with fully-taxed assets • At the same time means harsher treatment for residential real estate than most other appreciating assets. • Under-taxation of capital gains on business and share assets remain	• Larger improvement than just taxing residential land. • Harsher treatment of land than business goodwill and other appreciating capital assets. • Under-taxation of non-land assets remains.
Efficiency and Productivity	• Capital gains taxation raises tax on capital income reducing incentive to invest and productivity • By itself, likely to reduce efficiency and productivity although net effect with business package could be productivity enhancing • Evens out taxation across activities with different percentage of capital gains • Lock-in effect	• Like land tax, taxing gains on unimproved value of land is a relatively efficient (non-distorting) source of revenue • Taxing gains on improvements increases neutrality of investment while increasing taxes on investment • Evens out taxation of rental residential real estate with fully-taxed assets • Under-taxation of capital gains on business and share assets remain • Lock-in effect on taxed assets	• As for taxation of residential land generally in respect of gains in the unimproved value of land • Taxing gains on improvements will increase neutrality while increasing taxes on investment • Increases lock-in effect for land held by businesses.

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Sustainability	• Broadening tax base and reducing untaxed income improves sustainability of tax base. • More robust if divergence between company and personal tax rates	• Broadens revenue base • Does not respond to divergence in tax rates	• Broadens revenue base more than residential only • Does not respond to divergence in tax rates
Integrity	• Reduces scope for companies to be used to shelter income from higher rates of personal tax • Stops conversion of income into capital gains • Reinforces fairness and sustainability gains	• Little effect on integrity outside of labour component of rental residential housing appreciation. • Will replace existing bright line rule, thus eliminating the boundary between land held for shorter and longer periods. • Need for rules for residential land rich companies, which will be complex and will create boundary issues	• Will improve taxation of labour component of all land appreciation (eg farms as well as residential housing) • Will replace existing complex rules taxing some sales of land. • Need for rules for land-rich companies, which will be complex and will create boundary issues. •

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Complexity	• Increases compliance costs for all taxpayers earning capital gains • Valuations of existing assets when tax comes into effect complex especially for business assets and private shares • Complex adjustment for shares of members of corporate groups • Most pressure for roll-overs • Definition of a land rich company only applicable where shareholder is a non-resident.	• Much smaller increase in compliance costs • Less pressure for roll-overs. • Increases compliance costs for residential landlords or landlords plus those with second homes. • Valuations of existing assets less complex than other business assets and private shares • Defining residential land rich companies, and taxing gains/losses, complex • Either complex adjustments required for basis of shares in residential land rich companies, or valuations of shares they hold when significant share parcels are sold	• Increases compliance costs for any taxpayer with land or shares in a land rich company • Valuation issues less complex than for comprehensive but more complex than for residential only • Defining land rich companies, and taxing gains/losses complex • Either complex adjustments required for basis of shares in all land rich companies, or valuations of land they hold when significant share parcels are sold • Increased pressure for roll overs.
Coherence	• More coherent due to more comprehensive definition of income	• Leaves incoherence of not taxing a portion of income	• As for residential property extension.

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Housing affordability	• Some small increase in rents and some fall in price of houses may occur	• If it applies only to rental property likely negative. Taxing gains on residential rental, but not second homes, will tend to reduce housing supply. • If also applies to second homes, some small increase in rents and some fall in price of houses may occur	• Less effect on housing than just taxing residential property, since less substitution of investment to non-residential land.

Economic considerations

4. The TWG minority recommended extending the taxation of capital gains to non-owner occupied residential real property (one member recommended excluding second homes) on the basis that there is evidence of consistent appreciation and of income from this asset being undertaxed. As set out in paragraph 35 of our previous Report, other forms of land also seem to appreciate consistently in value. The Corelogic data is repeated here for convenience. The data is for the unimproved value of land.

Average annual increase in median land value per hectare 1993-2017

Residential	8.4%
Commercial	6.2%
Industrial	7.1%
Dairying	7.1%
Pastoral	8.2%

5. Taxing all gains in land (which includes improvements such as buildings) is an intermediate option between the comprehensive tax suggested by the Tax Working Group majority, and the minority opinion regarding residential rental land.

6. Taxing all gains on land would not be expected to cause large reallocations of resources in the economy for the simple reason that land is in fixed supply. Because of its fixed supply, taxing land tends to be regarded as a relatively efficient tax, as behaviour is distorted less (or not at all) in response to the tax. However, realisation-based taxes do affect the timing of realisations (i.e. there is a lock-in effect that prevents sales of land that would otherwise occur) which has an economic cost. Taxing gains on improvements will tend to increase neutrality (as most other returns on investment are already taxed) but have some deterrent effect on investment.

7. As with taxing gains on residential property, taxing all gains on land would be doing little to increase integrity or sustainability. It would do less to increase progressivity and horizontal equity than a general tax on capital gains but more than a tax on residential property only. It would have intermediate effects on efficiency and productivity and on compliance costs. It is likely to create greater compliance costs than a tax on residential real property only because new boundaries would be created which will create additional administration, enforcement and compliance costs. At the same time the additional compliance costs are likely to be significantly smaller than for a general tax on capital gains. It would also raise an intermediate amount of revenue creating less scope than a general tax to meeting the Government's set of objectives but more than a tax on residential property only.

General comments on design/complexity issues

8. A tax on non-owner occupied residential land may appear to be relatively simple from a design perspective, particularly as such land is already taxable if sold within five years. However, compared to the status quo it will give rise to some complexity, particularly in the following areas:

- The need for valuations, if the tax is introduced on a valuation day rather than a grandfathered basis (valuation is recommended by both the TWG and officials);
- Increased pressure for roll-overs in relation to land transferred by way of gift and inheritance;
- The need for rules to tax sales of land rich companies, in order to ensure the integrity of the tax. This is possibly the most complex of the three issues, and is considered in more detail below.

9. A tax on capital gains from all land (rather than only residential land) will increase the pressure and complexity in all of these areas.

- The number of valuations required on valuation day, and their complexity, will increase. Extending the tax to all land will also put significantly greater pressure on property valuations on an on-going basis, since it will often be the case that non-residential land is sold together with business goodwill, creating a need to apportion the global purchase price between the taxable land and the non-taxable goodwill
- There will be increased pressure for roll-overs or concessions, for example in relation to:
  - "like kind exchanges", where a small business sells one piece of land and replaces it with another;
  - retirement concessions.
- The potential application of the land rich company rules will expand.

10. This report now considers these three issues in turn, on the assumption of an extension of taxation to capital gains on all land.

Valuation of land in business sales

11. Extending the tax to all land only will require tax to be paid on a value established by reference to valuation when land is:

- held on valuation day, in which case the valuation will establish the cost base of the land. The need for valuation day values has been reported on already. A benefit of taxing only land is that it will eliminate the need to value business goodwill;
- sold along with other assets, eg plant and equipment or trading stock. In this case a valuation will be necessary to establish the portion of the sale price that should be allocated to the land in order to determine the seller's taxable income and buyer's cost basis. This is already the case in most business sales, where the vendor is taxable on the amount allocated to trading stock and depreciable property (up to original cost) but not on other items, such as goodwill and (currently) most land. The global price should be allocated in accordance with market values. However, by allocating more of a global price to non-taxable assets such as goodwill, the vendor can reduce its tax liability. It is difficult for Inland Revenue to challenge allocations, in part because valuation is not a precise science.

12. So long as the vendor and purchaser are required to use the same values, in most cases this will impose a natural brake on the vendor's ability to over-allocate a global price to non-taxable assets. The purchaser will be reluctant to agree to an over-allocation because it will reduce the purchaser's tax deductions. Currently, the requirement for consistency is not as clear as it should be, and this should be addressed in the case of a land-only extension. Some protection can also be

provided by requiring the use of registered valuers for larger transactions, and providing safe harbour methods and non-binding guidance.

13. Provided adequate resources are available to provide some level of Inland Revenue scrutiny, officials believe valuation issues should be manageable. However there is still an increase in compliance cost and complexity compared to the residential property only proposal.

Increased pressure for roll-overs

14. Taxing all land may lead to increased pressure for roll-overs, as compared to taxing only residential land. An obvious example is where a business sells its existing premises and acquires new ones. The argument is made that taxing this kind of transaction discourages economically efficient transactions. That is true, but allowing roll-over relief (where there is no tax on the gain on sale but the tax basis of the replacement asset is deemed to be the tax basis of the original asset) simply defers the problem, and creates design complexity and increased compliance costs.

15. The following table compares the cases for roll-over under a comprehensive or land-restricted extension.

Comparison of other technical issues raised by comprehensive versus limited extensions of capital gains tax			
Technical issue (references are to TWG Final Report Vol.II)	**Comprehensive**	**Residential land only**	**All land**
Roll-overs for corporate re-organisations (chapter 3 para 21)	TWG recommends roll-overs for • Switching between trading structures • Transfers within a wholly owned group • Qualifying amalgamations • De-mergers • Scrip for scrip exchange	May be able to be omitted or simplified, given that assets are not business assets	Probably require the same suite of roll-overs as the policy objective of not wanting to discourage efficient business restructures still applies.
Small business roll-over (chapter 3 paras 28-30)	TWG recommends roll-over for gains on sale of qualifying business assets by small businesses if proceeds reinvested.	Recommendation not applicable	Recommendation will need to be considered.
Small business retirement exemption/concessions (chapter 3 para 32)	TWG recommends concessional rate for first $500,000 of capital gain by retiring long-term business owner	Recommendation not applicable	Recommendation will need to be considered.

Land rich companies

16. Potentially the most complex design issue is how to deal with land held in companies. For example, suppose a natural person, or a company, holds land

acquired for either investment purposes or use in the person's own business, through a special purpose company. Suppose then that the person wants to sell the land, or the entire business, and that the land has increased in value. If there is a tax on sale of the land, but there is no tax on the sale of the shares, selling the shares is an obvious way to avoid the imposition of the tax. This is not an issue in a comprehensive extension of tax on capital gain, where share sales are taxed.

17. If the sale of shares in land-owning companies is not taxed, at least in some circumstances:

- that will encourage those investing in land to do so through companies, which will distort economic activity. For example, passive investors wanting to invest in land will be encouraged to do so through listed or unlisted property companies rather than direct ownership or via a partnership.
- companies and individuals will be encouraged to hold land in special purpose companies which can be sold without incurring tax.

Possible solutions

18. Possible solutions to this issue are as follows.

- do nothing and accept the potentially very significant loss of tax revenue that would result. This is the approach we already take in relation to most taxable land, trees and minerals, but those are all cases where the nature of the activity means an asset sale is inevitable in the short or medium term;
- tax sales of shares in companies, whether resident in New Zealand or elsewhere, which hold land, either entirely or partially, with or without exceptions. This will address the deferral and investment distortion issues, but creates other complexities.

Each of these solutions is considered further below.

Do nothing

19. As referred to above, gains and losses on some categories of land are already taxed in New Zealand, without there being any provisions to deal with the possibility of deferral using a company to hold the land. This does lead in practice to some element of deferral, for example in the forestry sector. However, the categories of land which are taxed are limited, and in many of them, the possibilities of deferral are, for various different reasons, also limited.

20. The only situation where sale of a land rich company is taxed is where the land is subject to the bright line rule. The bright-line rule is discussed in further detail in the Appendix.

21. In Malaysia and Cyprus, where land is generally the only asset subject to CGT, there are provisions to tax sales of shares in land rich companies. This is discussed in more detail below.

22. If gains on all sales of land become taxable, and there were no rules to tax shares in land rich companies, it seems inevitable that most land, particularly in a commercial context, would be held by special purpose companies, so that ownership of appreciated land could be transferred by sale of shares in a land-owning company without triggering the tax obligation. The tax would thus raise relatively little revenue, but would impose deadweight costs on the economy due to the complexity which ownership of land through separate companies would cause.

23. Doing nothing to deal with land owning companies would be a very significant weakness in a proposal to impose tax on gains from sales of land.

Tax sales of shares in land rich companies

24. The alternative to doing nothing is to tax sales of shares in land rich companies.

25. The purpose of a land rich company rule may be:

    - A broad "economic equivalent" purpose, which would justify taxing any sale of shares in a land rich company:

    - A more avoidance focussed purpose, which would limit the rule to taxing sales of shares which are substitutable for a sale of land. For example, such a rule would prevent people avoiding the tax by putting any land they own in a special purpose company, and selling the shares in the company rather than the land.

26. There is already an anti-avoidance rule of this nature in the bright-line tax, but if the tax on the sale of land (both residential and all-land) were to become more common, an explicit taxing rule would be needed.

27. There are a number of design issues that would be need to be considered:

- How much land must the company own to be considered "land-rich" (eg, 50%?),

- How much of the shares must the shareholder own or sell before being subject to tax? For example, 100%, 50%, 20%, any shares?

- How much of the gain should be taxed? All of the gain from selling the shares, or just the gain attributable to land?

- If there are other shareholders who do not sell, what are the consequences for them or the company?

- Whether to apply to companies that are land-rich but operate a business that is more complex than investing in land. Examples include electricity generation companies and retirement villages.

- How to apply to companies that invest in land on behalf of portfolio shareholders? Examples in include property trusts and property PIEs.

28. Working through these issues would require significant consultation. Further technical discussion of land-rich companies and some precedents are discussed in an appendix to this report.

APPENDIX: LAND RICH COMPANY ISSUES

Precedents

1. There are four precedents we are aware of for taxing land rich companies.

Tax treaties

2. While the relevant provisions differ, as a general proposition treaties allow (but do not require) a country to tax the sale of shares in a company that at any time in the 12 months before the sale derived more than 50% of its value from real property in the country (see Article 13(4) of the 2017 OECD Model Convention). The OECD Model Commentary mentions various possible amendments to this provision including:

   - changing the 50% threshold;
   - an exclusion for shares in listed companies;
   - an exclusion for property held in connection with an active business, eg a hotel or a mine;
   - limiting the provision to where the vendor holds more than a certain percentage of the company's shares.

3. The reason for the 12 month rule is to prevent shareholders escaping source country tax on their shares by injecting new assets into the company shortly before sale, thus diluting the percentage of the company's value made up by real property. The OECD Commentary recognises that where the decline in the percentage during the 12 months leading up to a sale is due to an actual sale of property by the company which has been taxed already, countries may limit the source country's right to tax the sale of the shares.

4. It is important to understand that land rich company treaty provisions do no more than create an exception to a general prohibition on source country taxation of capital gains. They do not have to deal with the problem of how to ensure such a tax works properly.

Bright line land rich company rule

5. The bright-line land rich company rule (section GB 52 of the Income Tax Act 2007) taxes a sale of shares in a company which owns land a sale of which would be subject to the bright-line, if:

   - the company's directly or indirectly owned assets consist 50% or more of residential land; and
   - 50% or more of the shares in the company are sold within a 12 month period with a purpose or effect of defeating the bright-line rule.

6. In this case, the selling shareholder is taxable on (broadly) the change in value of the bright-line property since it was acquired by the company up until the date of sale. This may be quite different from their actual gain or loss from selling the shares.

7. Officials do not know whether this rule has ever been applied. As drafted, it may not be sufficiently robust or detailed to deal with land rich companies where there is no time limit on revenue account status. For example, it is unlikely that a tax avoidance purpose requirement would be appropriate in that context, s9(2)(g)(i) s9(2)(g)(i) [redacted] But it is a useful indication of a possible approach.

The Malaysian rule[8]

8. Malaysia does not have a general tax on capital gain, but does tax capital gains from sale of Malaysian real property. The rate starts at 30% but declines to either 5% or 0% after 5 years (0% for Malaysian individuals). To buttress this tax, it also taxes gains on sale of shares in a real property company (RPC). An RPC is a "controlled company" which at the time of sale holds Malaysian real property which it acquired at a time when such property made up at least 75% of the value of the company. A controlled company is one with less than 50 shareholders which is controlled by five or fewer shareholders. The tax rate is on the same sliding scale as it is for the tax on property. However, the time period applies to the period for which the person holds the shares. Unlike the New Zealand rule, the period for which the company has held the land does not seem to be relevant.

The Cyprus rule

9. Like Malaysia, Cyprus taxes gains on sale of real property (at 20%). To support this tax, it also taxes gain from sales of shares in unlisted companies which own Cyprus property directly, and from sales of shares deriving more than 50% of their value directly or indirectly from property in Cyprus. It appears that only the portion of the gain that relates to the change in value of the property is taxable (ie the same approach taken in the bright line land rich company rule). We have not been able to find any more detail on this rule.

Comment on precedents

10. These precedents illustrate some of the issues that would need to be considered in defining what a land rich company is, and in calculating the taxable gain on sale of shares in such a company. A more systematic examination of the issues follows.

Technical issues raised by the need to deal with land rich companies in an extension of taxation to all gains on sale of land

11. If the decision were made to tax gains from sale of land rich companies as part of an extension of tax to all land, the technical rules that will need to be considered fall broadly into the following categories.

- Defining when a person's shares in a company are subject to tax on the basis that the company is land rich.
- Determining how much gain to tax. This is not at all straightforward.
    - If the entire gain is taxed on sale of the shares is taxed, it raises the complex basis adjustment rules referred to in chapters 7 and 10 of the TWG Report, which are different depending on whether the shareholder is an individual or a company, and whether the land rich company is a member of a wholly owned group, an imputation group, a tax consolidated group, or not a member of a group at all.
    - If only the gain (or loss) attributable to the property is taxed, these adjustments may not be needed, but the portion of the gain or loss on sale of the shares that is attributable to property will need to be determined.
- If the entire gain or loss on sale of shares is taxed, dealing with the transitional issues that arise when a person's shareholding becomes or ceases to be subject to the rules (in cases where that happens either after the person acquired the shares, or while they still hold the shares)

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[8] Malaysian information comes from https://realestate.bakermckenzie.com/tax/.

- Considering whether or not the various corporate roll-over reliefs (eg for share for share take-overs and demergers) should apply to transactions involving shares in land rich companies;

- Considering how the rules should apply to KiwiSaver and other managed investment entities holding shares in land rich companies (unless the definition of a land rich company means it is unlikely one would be held by such an entity)

There is a degree of interdependence between some of these issues.

12. Consideration will also need to be given to how any new rule will affect shares in companies whose land is already taxable outside of the brightline. There will also be miscellaneous consequential issues[9].

When should shares be subject to tax on the basis that the company is land rich

General discussion

13. There are two possible bases for a land rich company rule. Which basis is chosen will determine many of the features of the rule.

    - The rule may be trying to ensure that a person who is economically invested in land is taxed on a realisation of their investment.

    - The regime may be trying to ensure that a person cannot easily replace a sale of land with a sale of shares, for the purpose of avoiding tax on a gain on sale of the land.

14. The distinction can be illustrated by considering some simple scenarios.

    - Listed property companies. These are common investment vehicles. Their assets will usually be nothing but land (which they lease to other businesses) and associated assets. Economically, ownership of shares in such a company is very much equivalent to owning land directly and employing a manager, except for the fact that pooling of investments allows access to much more expensive buildings. If a land rich company rule is intended to capture gains on sales of interests in land, then such a company would be land rich. However, a person who sells their shares in such a company does not have a choice of instead selling land, and is not doing so as a way of avoiding tax on such a sale. If the focus of a land rich rule is on the issue of substituting sales of land with sales of land owning companies, the listed property company is not land rich.

    - A subsidiary of a listed property company. If the listed property company itself sells land, the sale will obviously be taxable. If the listed property company holds land through a special purpose subsidiary, should a sale of that subsidiary also be taxable? Arguably the subsidiary provides useful non-tax benefits, such as limited liability and possibly a useful focus for management and financial reporting. However, those benefits are only relevant while the listed property company (indirectly) owns the land. They do not require that a sale of the land occur by way of sale of the subsidiary. Accordingly, such a subsidiary company should be land rich.

    - A portfolio of rental properties, owned ultimately by a single family or family trust, held in a holding company structure with each property owned by a separate subsidiary. For similar reasons to those considered immediately above, both the subsidiaries and holding company should be land rich.

[9] Such as the need to adjust available subscribed capital in the affected companies by the amount of the gain or loss

- An operating company, owned by an individual or family trust, which owns its own premises. Under current law, sales of businesses are in fact done by way of sale of shares or assets, for reasons that usually include but are not limited to the different tax treatment of the transaction. Imposition of tax on sales of land will undoubtedly encourage such a sale to be done by way of shares if the land has appreciated (and by way of assets if it has not), but it will not change the nature of the choice. This might suggest that in most cases, such a company should not be defined as land rich. However, if land is fundamental to the business (which may be determined by reference to the proportion of the value of the assets made up by land), the importance of the different tax treatment may be sufficiently significant that the company should be defined as land rich. An obvious example is a company which owns a farm. Depending on where the threshold is set, it might also include a company owning a relatively unsuccessful business operating from inner city land. Possible value thresholds are 50% (as in the model tax treaty) or 75%. It may be useful to consult on what sort of companies would be captured by these thresholds. These would need to be supported by anti-stuffing rules.

15. Moving on from these simple scenarios, the third and fourth scenarios can be modified by supposing that there are two, or three, or twenty five, unrelated investors. The connection between them may be relatively close (eg there may be a detailed shareholders or incorporated joint venture agreement) or more distant. The greater the number of shareholders, the less substitutability there is between selling shares and selling land.

16. The second issue that needs to be considered in this section is whether the rule should only apply to a shareholding of more than a certain size, eg 10%. An argument in favour of such a minimum is that a sale of a portfolio interest in a land owning company is quite different from a sale of an interest in the land itself. However, if the shareholder is selling their shares along with a large number of other shareholders (eg in the context of a take-over offer pursuant to drag-along tag-along rights) it might seem arbitrary to tax some shareholders and not others.

Straw man

17. As a straw man for discussion, a possible definition could be based on the CFC definition, which defines when income earned by a foreign company may be attributed to New Zealand shareholders. On this basis, a company would be a land rich company if it is owned as to 50% or more by five or fewer investors (counting associated persons as a single investor) and either 50% or 75% or more of its value is made up of real property. Valuation could be based on the most recent set of consolidated accounts of the company, possibly adjusted for any major or non-ordinary course transactions.

18. It may be appropriate to amend this test so that it is met only if 50% or more of the company is owned by a smaller number of investors, eg two or three. As a practical matter, the problematic use of land rich companies will most commonly arise where land is owned by one or two investors (again, treating associates as a single investor).

19. At least in some contexts, it may be tempting for shareholders to assume their company is not land rich, rather than making enquiry at the time of sale. It might be appropriate for companies who are not clearly excluded from being land rich (as listed companies might be, for example) to be under an explicit obligation to provide such information to shareholders, since the company is in the best position to know the facts.

How much should be taxed?

20. As referred to above, there are two approaches to this issue.

- Put land rich holding company shares on revenue account (the "taxable shares approach"). This appears to be the approach taken by Malaysia.

- Attribute to the selling shareholder their share of the change in value of the land held directly or indirectly by the company (the "land attribution approach"). This is the approach taken in the bright line land rich company rule, and apparently by Cyprus.

Revenue account approach

21. The taxable shares approach is considerably technically more complex than the land attribution approach. It requires

    - complex share basis adjustment rules

    - property basis adjustment rules to prevent double deduction of losses

    - rules to deal with situations where a company becomes or ceases to be land rich.

    Example

    Suppose a family trust holds a portfolio of investment properties through a single holding company, which in turn owns each property through a subsidiary. Suppose the trust wants to sell a property, which has increased in value from $1m to $2m during the trust's period of ownership. If the subsidiary sells the property, it will have a taxable gain of $1m. If the parent sells the subsidiary for a gain, assuming the subsidiary is land rich, that gain will also be taxable. However, the gain on sale of the shares in the subsidiary can be quite different from its gain from sale of the property. Suppose for example that immediately prior to sale of the shares, the subsidiary borrows $1m from its parent, and uses the funds to pay the parent a dividend, which would be tax exempt. This will reduce the value of the shares by $1m. Prima facie, a sale of the shares in the subsidiary will therefore give rise to $1m less profit than if the dividend had not been paid.

22. Rules that prevent this kind of tax planning are referred to in the TWG Interim and Final Reports. They are amongst the most complex of the rules required by a comprehensive tax on capital gains. The third set of rules, dealing with transitional situations, have not been considered to date. Officials' preliminary view is that they will also be very complex.

23. If these rules are not enacted on a fully considered basis, tax planning structures can be used which not only eliminate tax on economic gains, but create tax losses in the absence of real ones. This is illustrated by New Zealand's experience with putting petroleum mining companies on revenue account – a rule that was abandoned in 2002 when tax planning using holding companies led to multiple deductions being claimed for a single economic loss.

Land attribution approach

24. The land attribution approach avoids most of these difficulties in adjusting the basis of shares and dealing with transitional situations. However, it means that any time a person sells shares in a land rich company, they (or more likely the company) will need to determine the accrued gain or loss on all land held directly or indirectly by the company. This will require not only valuations, but a level of co-ordination between the company and the shareholder.

25. In the example set out above, the sale of shares in the subsidiary would be a taxable event for the parent, but the amount of income would always be $1m, being the movement in the value of the property. The subsidiary's cost base in the property would increase to $2m.

26. For the land rich rule to apply in the first place, the value of the property owned directly and indirectly by the company will need to have been determined. The additional factor that will need to be considered in order to determine the shareholder's taxable gain or loss (which may be larger or smaller than their actual gain or loss) is the tax cost of the property. It may be possible to rely on the most recent balance sheet and tax returns of the company, at least in some cases, and to put the company (which will be in possession of the relevant facts) under an obligation to provide this information to the shareholder. The company will need the information in order to adjust its cost base in the property.

27. An issue with this approach is that where only part of a company is sold, the increase in the tax basis of the land will create a benefit for all shareholders (by way of reducing the amount of gain when they sell their shares), not just the purchasing shareholder. This may significantly discourage or complicate such sales.

28. The technical and practical challenges of either a taxable share approach or an attribution approach are considerable

Inland Revenue
Te Tari Taake
POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Options for building a package of tax reform

Date:	22 February 2019	**Report No:**	T2019/341 IRD2019/103
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Indicate** what additional information is needed to inform your development of a package of tax reform.	25 February 2019
Minister of Revenue (Hon Stuart Nash)	**Indicate** what additional information is needed to inform your development of a package of tax reform.	25 February 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Mark Vink	Manager, Tax Strategy, The Treasury	s9(2)(a)	
Matt Benge	Chief Economist, Inland Revenue		
Shane Domican	Senior Analyst, The Treasury		✓

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Options for building a package of tax reform

Executive Summary

This report is intended to support decision-making on a potential package of tax reform for Budget 2019. It provides information on:

- The fiscal context;
- The revenue generated by different options for extending capital income taxation; and
- The costs and impacts of potential revenue-negative measures for tax reform.

This report also responds to your request for further information on:

- s9(2)(f)(iv) [redacted]
- An illustration of the s9(2)(f)(iv) [redacted] alongside an extension of capital income taxation;
- The fiscal impact of capping tax rates on capital gains at 28%; and
- s9(2)(f)(iv) [redacted]

This report has been prepared under time pressure. The costings and impact analysis are preliminary only and subject to further refinement.

The fiscal parameters for the package

In designing a package, a key choice relates to the fiscal parameters of the package. A package could increase revenue ('revenue-positive'), reduce revenue ('revenue-negative'), or have a broadly neutral impact on revenue ('revenue-neutral').

Any tax reform package will need to be consistent with the Government's fiscal strategy. In order to comply with the Budget Responsibility Rules, any package will need to be consistent with maintaining sustainable operating surpluses and reducing net core Crown debt to 20% of GDP within five years of the Government taking office. As the fiscal impacts of tax reform mostly occur after 2021/22, there are also judgements required about the desired path for tax revenue in the long term.

The table below indicates three potential sources of funding for revenue-negative measures: revenue from taxing capital gains, fiscal drag; and/or using fiscal headroom within the constraints of the Budget Responsibility Rules.

Fiscal drag could provide revenue for revenue-negative measures while maintaining tax revenue as a stable percentage of GDP. This is because fiscal drag will cause tax revenue to rise as a percentage of GDP unless personal tax thresholds are adjusted. The Government's medium-term fiscal projections (beyond the five-year forecast horizon) have a technical assumption that tax revenue will remain at a stable percentage of GDP. This means that future policy changes to maintain tax revenue at a stable percentage of GDP are already assumed in the medium-term fiscal projections.

Package type	Revenue-negative measures funded from…
Revenue-neutral or revenue-positive package	Revenue from **an extension of capital income taxation**

Package type	Revenue-negative measures funded from…
Revenue-negative package while maintaining tax revenue as a percentage of GDP.	Revenue from **an extension of capital income taxation** and **fiscal drag**
Revenue-negative package while reducing tax revenue as percentage of GDP.	In addition to revenue from an extension of capital income taxation and fiscal drag, using **fiscal headroom** within the constraints of the Budget Responsibility Rules (through some combination of lower operating surpluses and/or reducing future Budget allowances). *The level of fiscal headroom will depend on other expenditure decisions taken in Budget 2019, and on the updated Budget forecasts.*

This report includes some preliminary modelling to illustrate the fiscal impact of potential tax reform package options.

The Treasury will provide integrated fiscal strategy advice to the Minister of Finance on 20 March. This will cover revenue and expenditure settings, alongside longer-term fiscal objectives.

Revenue from taxing capital gains

Modelling commissioned for the Tax Working Group indicates that a broad-based extension of capital income taxation could raise $8.3 billion over five years. Officials have continued to refine these estimates. On current estimates, the total level of projected revenue is roughly the same, but the composition of revenue has changed with more stemming from shares and less from real property.

Implications of partial asset coverage

The revenue available for a package will depend on the design of the tax. The revenue from taxing gains on partial asset coverage is as follows (over five years):

- $2.3b if only residential investment property and second homes are taxed; and
- $4.3b if only real property is taxed.[1]

Implications of changing the top rate

The revenue from taxing capital gains at a maximum rate of 28% is outlined below:

Table 1: Forecast revenue from taxing capital gains with a capped rate of 28%

$billion	2021/22	2022/23	2023/24	2024/25	2025/26	Five year total
Total – with capped 28% rate	0.4	0.9	1.5	2.1	2.6	7.5
Total – with marginal rates applying	0.5	1.0	1.6	2.2	2.8	8.2

Note: There is significant uncertainty in the revenue impacts of taxing capital gains with a capped rate. This costing has been carried out on a static basis and does not incorporate any wider impacts. A capped capital gains rate would have significant impacts on the integrity and simplicity of the regime for taxing capital gains and would likely create additional compliance and administration costs. These, and other issues, would need to be considered further if this option is pursued.

Volatility and revenue sustainability

We will provide additional advice on other design features of taxing capital gains. Decisions on some of these features could have significant fiscal impacts. For example, taxing non-

[1] We are advising you separately on the option of taxing real property only (IR 2019/085, T2019/403 refer). As outlined in that advice, taxing real property only will create opportunities to defer or avoid the taxation of this property through the use of land-rich companies. This could reduce revenue, but officials have not quantified the potential revenue impact.

Australasian shares on capital gains and dividends rather than on a Fair Dividend Rate (FDR) basis could raise an estimated additional $1-$1.5 billion over five years.[1] However, compared with retaining the FDR regime, the actual revenue stream from this change would be much riskier, as there would be greater revenue volatility as the returns would depend on the performance of foreign share markets. The TWG recommends retaining the FDR regime. We will report to you further on the key policy issues that need to be considered on this design choice.

Forming a package of tax reform

A second key choice will relate to the focus and composition of any fiscally-negative components of the package. Potential fiscally-negative options fall under three broad categories:

Category	Options
Income support	s9(2)(f)(iv) [redacted] • Welfare measures (for example, drawing on the Welfare Expert Advisory Group's report)
Productivity	• Business measures
Savings	• KiwiSaver measures • Broader saving measures
Housing	• Housing measures

An early indication on the relative areas of focus in the package will help officials focus design work on the areas of greatest priority to you.

Interactions with the Wellbeing Budget

There is also a question regarding the interaction between the broader Wellbeing Budget and a package of tax reform. The Government has committed to release a 'full response' to the Tax Working Group's report in April 2019.

It would be helpful for officials to understand how tax reform may interact with the other aspects of the Wellbeing Budget (which would then have implications for the timing and content of any announcements in April).

The costs and impacts of the options

The tables annexed to this report provide a summary of the fiscal costs and potential wellbeing impacts of fiscally-negative options for tax reform that we have discussed with you to date. This information is intended to support your decision-making on the size and composition of a package of tax reform. A summary of this information is provided below:

s9(2)(f)(iv)

[redacted]

Policy options	Range of fiscal costs over five years	Officials' comment
s9(2)(f)(iv) [redacted]		
	Savings	
Adjust KiwiSaver parameters	$0.6 – $2.6 billion	**Distributional impacts:** Will provide additional support to lower income savers. But changes to personal income tax and transfer settings are a more effective way to support lower-income households. **Saving impacts:** Unlikely to have a material impact on overall private saving.
Move KiwiSaver to EET system	$15.4 billion	**Saving impacts:** Defers taxation of contributions into future. Ultimate impact on private savings and investment difficult to assess. Will likely decrease national savings.
Move KiwiSaver *and* similar schemes to EET system	$24.1 billion	
	Business	
s9(2)(f)(iv) [redacted]		
Loss carry-forwards	$0.2 billion	s9(2)(f)(iv) [redacted]
'Black-hole' expenditure	$0.1 billion	
s9(2)(f)(iv) [redacted]		
s9(2)(f)(iv) [redacted]		
	Housing	
Remove rental loss ring-fencing	$0.8 billion	**Housing impacts:** Will encourage new housing supply and reduce pressure on residential rents.
s9(2)(f)(iv) [redacted]		

Next steps

We will discuss this report with you at the Joint Ministers meeting on Monday 25 March.

Recommended Action

We recommend that you:

a **note** that you will receive complementary advice on the following issues:

i. Options for an extension of tax on capital gains to different asset types (22 February)

ii. Detailed design for taxing capital gains (intended for week beginning 25 February)

Key design choice 1: Fiscal parameters

b **indicate** your preferences regarding the fiscal impact of the package and any additional advice required**:**

Option	Please tick preferred option	Please state any additional advice required
Revenue-positive package		
Revenue-neutral package		
Revenue-negative package		

Key design choice 2: Focus of package

c **indicate** your preferences regarding the key focus (or focuses) of the package and any additional advice required:

Potential focus	Please tick preferred focus(es)	Please state any additional advice required
s9(2)(f)(iv)		
Welfare		
Business		
KiwiSaver		
Broader saving measures		
Housing		

Key design choice 3: Interaction with the Wellbeing Budget

d **indicate** how tax reforms may interact with other aspects of the Wellbeing Budget.

e **note** that this decision will have implications for the content and timing of any announcements in April.

Further information

f **indicate** whether you require any further analysis or information to support the development of a package of tax reform.

Yes / no *Yes / no*

Mark Vink
Manager, Tax Strategy, Treasury

Matt Benge
Chief Economist, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Tax Policy Report: Options for building a package of tax reform

Purpose of Report

1. This report is intended to support decision-making on a potential package of tax reform for Budget 2019. It provides information on:

   - The fiscal context (paragraphs 3 - 22);
   - The revenue generated by different options for extending capital income taxation (paragraphs 23 - 34); and
   - The costs and impacts of potential revenue-negative measures for tax reform (paragraphs 35 – 42, Appendix A-B).

2. This report also responds to your request for further information on:

   - s9(2)(f)(iv) [redacted]
   - The fiscal impact of capping tax rates on capital gains at 28% (paragraph 31);
   - Preliminary modelling of the distributional impact of extending capital income taxation s9(2)(f)(iv) [redacted] and
   - s9(2)(f)(iv) [redacted]

Fiscal context

Revenue impacts should be consistent with the Government's fiscal strategy…

3. The Tax Working Group presented you with options for a revenue-neutral package, in which the revenue from taxing capital gains over the first five years is used to pay for revenue-negative items.

4. However, there are other options that could be considered for tax packages. A key choice is the net fiscal impact of the package. You have the choice of implementing a revenue-positive, revenue-negative or a revenue-neutral package.

5. In order to comply with the Budget Responsibility Rules, any package will need to be consistent with maintaining sustainable operating surpluses and reducing net core Crown debt to 20% of GDP within five years of the Government taking office.

… and revenue-negative measures could be funded from capital gains, fiscal drag, or projected fiscal headroom

6. In a revenue-positive or revenue-neutral package, measures with a fiscal cost could be funded from the revenue from taxing capital gains. Fiscal drag would also provide revenue for revenue-negative measures, while broadly maintaining tax revenue at a stable percentage of GDP.[2]

7. Figure 2 shows the fiscal forecasts (based on HYEFU assumptions). This includes the HYEFU forecast period to 2022/23, and projections from 2023/24.

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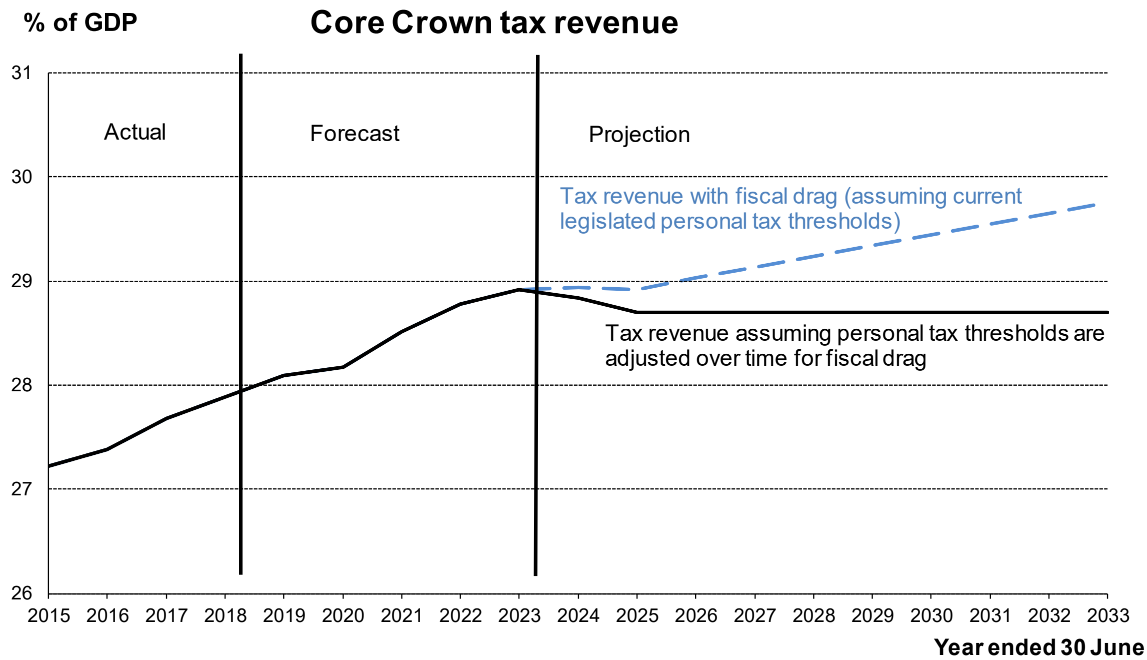
[2] Fiscal drag occurs when higher average tax rates apply to taxpayers as their incomes increase over time, unless tax thresholds are adjusted.

8. The projections in the *Fiscal Strategy Report* and *Budget Policy Statement* assume that tax revenue remains stable as a percentage of GDP in the projection period. This relies on a technical assumption that fiscal drag will not occur (i.e. that there will be future adjustments to personal income tax thresholds).

9. In order to show the impact of fiscal drag, Figure 2 shows an alternative projection in which fiscal drag leads to rising personal tax revenue as a share of GDP. Over the projection years from 2023/24 to 2025/26, fiscal drag is projected to provide approximately $2.6 billion in additional cumulative tax revenue (compared with tax revenue remaining stable as a percentage of GDP).

Figure 2: Core crown tax revenue with and without fiscal drag



Note: The figure is based on HYEFU 2018 forecasts with alternative projections assumptions. The solid line assumes that personal tax revenue is a stable share of GDP. The dashed line assumes that fiscal drag leads to rising personal tax revenue as a share of GDP. Other tax types are assumed to converge to a stable percentage of GDP.

10. In addition to revenue from an extension of capital income taxation and fiscal drag, a revenue-negative package could be funded from projected fiscal headroom within the constraints of the Budget Responsibility Rules. This would require some combination of lower operating surpluses and/or reducing future Budget allowances.

11. The table below summarises the three potential sources of funding for revenue-negative measures:

Package type	Revenue-negative measures funded from…
Revenue-neutral or revenue-positive package	Revenue from **an extension of capital income taxation**
Revenue-negative package while <u>maintaining</u> tax revenue as a percentage of GDP.	Revenue from **an extension of capital income taxation** and **fiscal drag**
Revenue-negative package while <u>reducing</u> tax revenue as percentage of GDP.	In addition to revenue from an extension of capital income taxation and fiscal drag, using **fiscal headroom** within the constraints of the Budget Responsibility Rules (through some combination of lower operating surpluses and/or reducing future Budget allowances).

Package type	Revenue-negative measures funded from…
	The level of fiscal headroom will depend on other expenditure decisions taken in Budget 2019, and on the updated Budget forecasts.

12. The level of fiscal headroom will depend on other expenditure decisions taken in Budget 2019, and on the updated Budget forecasts.

13. The Treasury will provide integrated fiscal strategy advice on 20 March. This will cover revenue and expenditure settings, alongside longer-term fiscal objectives.

Preliminary modelling of the impact of options on the long-term fiscal position

s9(2)(f)(iv)

[redacted]

All of the illustrative packages are consistent with the maintenance of operating surpluses…

15. In each case, the Government is projected to maintain operating surpluses. However, the illustrative packages would reduce the size of the Government's operating surplus (assuming that the Budget operating and capital allowances are unchanged).

16. Lower surpluses will create greater risks for the Government if economic conditions worsen (particularly because capital gains are a volatile source of revenue). However, there are choices for the setting of future Budget operating and capital allowances that could also be considered to achieve the Government's fiscal objectives.

...but the illustrative packages risk the achievement of the net debt target

17. Net core Crown debt will be above 20 percent of GDP in 2021/22 for all of the illustrative packages that s9(2)(f)(iv) [redacted]. In the other packages, net core Crown debt will be between 19.2% of GDP and 19.8% of GDP.

18. The illustrative packages would reduce the buffer available to meet the Government's targets if economic conditions worsen. Updated Budget forecasts and decisions taken in Budget 2019 may also reduce fiscal headroom against the net debt target. Therefore, revenue-negative packages with significant fiscal impacts may need to be deferred or scaled down to be consistent with the net debt target.

19. Table 4 below provides preliminary modelling of the expected impact on net core Crown debt of each of the nine illustrative packages (based on HYEFU forecasts).

Table 4: Impact of illustrative packages on net core Crown debt

Package		Preliminary projection of net core Crown debt in 2021/22 (as a % of GDP)
Tax capital gains from residential property and a	s9(2)(f)(iv) [redacted]	[redacted]
Tax capital gains from all real property and a	[redacted]	[redacted]
Tax capital gains comprehensively	[redacted]	[redacted]

Note: Indicative estimates based on HYEFU economic and fiscal forecasts.

20. The choice of what asset types to extend capital gains taxation to, is not projected significantly impact net core Crown debt in 2021/22. This is because capital gains revenue is expected to build up slowly and not provide significant revenue in 2021/22 (the first year the rules apply from).

21. Figures 5-7 provide preliminary modelling of the impact on the Government's fiscal position of the most revenue negative option outlined in the above table (taxing only residential property, s9(2)(f)(iv) [redacted]

Note: Page 12 has been removed under section 9(2)(f)(iv) OIA

Figure 7: Illustrative impact of potential tax package on core Crown tax revenue

s9(2)(f)(iv)

22. All of these illustrative estimates are preliminary, and have been prepared on HYEFU projections. The projections are subject to change from updated Budget forecasts, other decisions taken in Budget 2019, further refinements to the fiscal estimates and incorporation of macroeconomic effects from the final tax package.

Updated revenue estimates for an extension of capital income taxation

Officials continue to refine and update the revenue estimates…

23. Modelling commissioned for the Tax Working Group indicates that a broad-based extension of capital income taxation (as designed by the Group) could raise $8.3 billion over five years.

24. This revenue forecast was conducted on a *tax year* basis – meaning that revenue was calculated on the basis of the tax year in which a taxpayer would sell their asset – rather than on a *fiscal year* basis (i.e. the fiscal year in which the Government is expected to accrue the revenue from the sale of the asset).

25. Officials have revised this estimate as part of a process for inclusion in Budget 2019. The aggregate figures are broadly unchanged as a result of these revisions. However, the composition of forecast revenue has changed: there is forecast to be more revenue from shares, and less from real property.

Table 8: Forecast revenue from taxing capital gains – by fiscal year

$billion	2021/22	2022/23	2023/24	2024/25	2025/26	Five year total
Residential investment property and second homes	0.03	0.2	0.4	0.7	1.0	2.3
Commercial, industrial and other real property	0.06	0.1	0.2	0.3	0.5	1.2
Rural property	0.07	0.1	0.2	0.2	0.3	0.8
Domestic listed shares held directly	0.1	0.5	0.7	0.8	0.9	3.0
Australasian shares held by managed funds (with a 10% discount)	0.2	0.2	0.2	0.2	0.2	0.9
Total	0.5	1.0	1.6	2.2	2.8	8.2[3]
Total as reported in Tax Working Group final report (for comparison)	0.4	1.0	1.7	2.3	2.9	8.3

26. The reason for these revisions are:

- The conversion from a tax year basis to a fiscal year basis. This process has decreased the expected revenue for most asset types, but in particular for real property.

- The inclusion of Australian listed shares held by non-KiwiSaver managed funds within the revenue estimate.[4] These shares were not included in the previous estimate due to data limitations which have since been overcome.

…so the revenue estimates are not yet final.

27. Officials are continuing to finalise the revenue estimates for inclusion in the budget process (which will include a consideration of wider macroeconomic impacts and consequential fiscal impacts).

28. The revenue estimates will also change to reflect design decisions made by Ministers (discussed in the next section).

29. Officials are also updating the revenue forecasts for some of the revenue-negative options s9(2)(f)(iv) [redacted] s9(2)(f)(iv) [redacted] Officials are updating estimates for other measures (particularly the business measures).

Partial coverage options will reduce the revenue available for a package…

30. The revenue available for a package will depend on the design of the tax. For example, the revenue from taxing capital gains with different asset coverage (over the first five years) is:

- $2.3b if only residential investment property and second homes are taxed; and

3 Numbers may not sum to total due to rounding.

4 The previous costing was on a more conservative base and only looked at domestic shares held by managed funds while the Tax Working Group recommended taxing domestic and Australian listed shares held by managed funds. This revision does not affect the analysis of the distributional impact of taxing capital gains in KiwiSaver accounts.

5 s9(2)(f)(iv) [redacted]

- $4.3b if only real property is taxed[6]

31. Other design details can have significant impact on the revenue from taxing capital gains. You previously requested the fiscal impact of capping the tax rate on capital gains to 28%. This is estimated to reduce the revenue form taxing capital gains to $7.5 billion over the first five years (Figure 2 below).

Table 1: Forecast revenue from taxing capital gains with a capped rate of 28%

Revenue ($b – fiscal years)	2021/22	2022/23	2023/24	2024/25	2025/26	Five year total
Total – with capped 28% rate	0.4	0.9	1.5	2.1	2.6	7.5
Total – with marginal rates applying	0.5	1.0	1.6	2.2	2.8	8.2

Note: There is significant uncertainty in the revenue impacts of taxing capital gains with a capped rate. This costing has been carried out on a static basis and does not incorporate any wider impacts. A capped capital gains rate would have significant impacts on the integrity and simplicity of the regime for taxing capital gains and would likely create additional compliance and administration costs. These, and other issues, would need to be considered further if this option is pursued.

...and the fiscal impacts can be complex to assess.

32. Officials will provide additional advice on other design features of taxing capital gains. Some of these could have significant fiscal impacts. At the same time, it can be complex to assess the potential fiscal impacts, because potential revenue streams may be more or less volatile.

33. For example, taxing non-Australasian shares on capital gains and dividends rather than on a Fair Dividend Rate (FDR) basis could raise an estimated additional $1-$1.5 billion over five years.[1] However, compared with retaining the FDR regime, the actual revenue stream from this change would be much riskier, as there would be greater revenue volatility as the returns would depend on the performance of foreign share markets. The TWG recommends retaining the FDR regime. We will report to you further on the key policy issues that need to be considered on this design choice.

34. The TWG recommends retaining the FDR regime, and officials will report to you further on this

Forming a package of tax reform

A key decision for you is the focus and composition of the package…

35. One key issue for your consideration relates to the focus and composition of the package. The options for tax reform fall under three broad categories.

Category	Options
Income support	• s9(2)(f)(iv) • • Welfare measures (for example drawing on the forthcoming report of the Welfare Expert Advisory Group)
Productivity	• Business measures

6 We are advising you separately on the option of taxing real property only (IR 2019/085, T2019/403 refer). As outlined in that advice, taxing real property only will create opportunities to defer or avoid taxation of this property through the use of land-rich companies. This could reduce revenue, but officials have not been able to quantify the potential impact.

Savings	• KiwiSaver measures • Broader saving measures
Housing	• Housing measures

36. Early indication on the relative areas of focus in the package will help officials focus design work on the areas of greatest priority to you.

…and how it will interact with the Wellbeing Budget

37. There is also a question regarding the interaction between the broader Wellbeing Budget and a package of tax reform. The Government has committed to release a 'full response' to the Tax Working Group's report in April 2019.

38. It would be helpful for officials to understand how tax reform may interact with the other aspects of the Wellbeing Budget (which would then have implications for the timing and content of any announcements in April).

The costs and impacts of the options

39. Appendix A outlines the fiscal costs and potential wellbeing impacts of various options for tax reform. A summary of this table is provided below.

40. Any package that extends the taxation of capital income is likely to enhance social capital, to the extent that it increases the horizontal equity and the integrity of the tax system. An extension of capital income taxation will also help the Government achieve its objective of building a more progressive tax system.

41. The options for tax reform will have impacts on different aspects of wellbeing. We have assessed the potential impacts on social capital, human capital, and physical and financial capital based on a range of indicators. The tables below do not cover natural capital, as it is not feasible to estimate the impacts arising from these measures on stocks of natural capital.

42. Officials are continuing to refine the estimates of the fiscal costs. They should be considered preliminary, and are provided here for early consideration by Ministers.

Policy options	Range of fiscal costs over five years	Officials' comment
	Income support	
s9(2)(f)(iv)		

Policy options	Range of fiscal costs over five years	Officials' comment
[redacted]		
	Savings	
Adjust KiwiSaver parameters	$0.6 – $2.6 billion	**Distributional impacts:** Will provide additional support to lower income savers. But changes to personal income tax and transfer settings are a more effective way to support lower-income households. **Saving impacts:** Unlikely to have a material impact on overall private saving.
Move KiwiSaver to EET system	$15.4 billion	**Saving impacts:** Defers taxation of contributions into future. Ultimate impact on private savings and investment difficult to assess. Will likely decrease national savings.
Move KiwiSaver *and* similar schemes to EET system	$24.1 billion	
	Business	
s9(2)(f)(iv) [redacted]		
Loss carry-forwards	$0.2 billion	[redacted]
'Black-hole' expenditure	$0.1 billion	
s9(2)(f)(iv) [redacted]		
	Housing	
Remove rental loss ring-fencing	$0.8 billion	**Housing impacts:** Will encourage new housing supply and reduce pressure on residential rents.
s9(2)(f)(iv) [redacted]		

Appendix A: Summary of revenue-negative package measures

s9(2)(f)(iv)

s9(2)(f)(iv)

[7] Note: as the measures apply from 1 April 2021, they apply for the last quarter of the Government's 2020/21 fiscal year. As a result the five year costing includes the final quarter of 2020-21 fiscal year.

Note: Page 19 has been removed under section 9(2)(f)(iv) OIA

s9(2)(f)(iv)

Policy option	Fiscal cost over five years (2020-2026)	Social capital	Financial and physical capital	Human capital	Officials' comment
s9(2)(f)(iv)					

Savings option

Policy option	Fiscal cost over five years (2021-2026)	Social capital	Financial and physical capital	Human capital	Officials' comment
10. Remove ESCT for contributions to KiwiSaver where employee earns less than $48,000 per annum	$1.1 billion	*Distributional impacts:* Increases progressivity of tax system and provides additional contributions to low income KiwiSavers. *Horizontal equity:* Would benefit those saving through KiwiSaver, but not those in similar schemes or who choose to save through different means.	*Incentives to save and invest:* Unlikely to significantly increase the amounts that individuals save *Compliance and administration costs:* Potentially complex with associated compliance and administration costs	No significant impacts identified.	These measures would provide additional support to lower income savers, but it is unlikely to have a material impact on private saving. If the Government's objective is to increase support for lower-income households then changes to personal income tax and transfer settings would be more effective than these KiwiSaver
11. Remove ESCT for contributions to KiwiSaver where employee earns less than $48,000 per annum. The exemption abates at 6 cents per dollar for every dollar earned above $48,000	$1.7 billion	*Distributional impacts:* Increases progressivity of tax system and provides additional contributions to low income KiwiSavers. Removes "fiscal cliff" of above option where those earning any amount over $48,000 receive no benefit. *Horizontal equity:* Would benefit those saving through KiwiSaver, but not those in similar schemes or who choose to save through different means.	*Incentives to save and invest:* Unlikely to significantly increase the amounts that individuals save *Compliance and administration costs:* Potentially complex with associated compliance and administration costs.	No significant impacts identified.	

Savings options continued

Policy option	Fiscal cost over five years (2021-2026)	Social capital	Financial and physical capital	Human capital	Officials' comment
12. Increase member tax credit to $0.75 per $1 of contribution (from $0.50 currently)	$2.6 billion	*Distributional impacts:* Measure is progressive and provides additional contributions to low income KiwiSavers. *Horizontal equity:* Would benefit those saving through KiwiSaver, but not those in similar schemes or who choose to save through different means.	*Incentives to save and invest:* Unlikely to significantly increase the amounts that individuals save	No significant impacts identified	These measures would provide additional support to lower income savers, but it is unlikely to have a material impact on private saving. If the Government's objective is to increase support for lower-income households then changes to personal income tax and transfer settings would be more effective than these KiwiSaver
13. Primary caregiver KiwiSaver member can receive full member tax credit in year of child's birth regardless of their KiwiSaver contributions	$0.1 billion	*Distributional impacts:* Increase progressivity of tax system and provides additional contributions to low income KiwiSavers, particularly women during maternity. *Horizontal equity:* Would benefit those saving through KiwiSaver, but not those in similar schemes or who choose to save through different means.	*Incentives to save and invest:* Unlikely to significantly increase the amounts that individuals save	No significant impacts identified	
14. Reduce lower PIE rates by five percentage points for KiwiSaver funds	$0.6 billion	*Distributional impacts:* Increase progressivity of tax system and provides additional contributions to low income KiwiSavers, particularly women during maternity. *Horizontal equity:* Would benefit those saving through KiwiSaver, but not those in similar schemes or who choose to save through different means.	*Incentives to save and invest:* Unlikely to significantly increase the amounts that individuals save *Compliance and administration costs:* Potentially complex with associated compliance and administration costs	No significant impacts identified	

-

Savings options continued

Policy option	Fiscal cost over five years (2021-2026)	Social capital	Financial and physical capital	Human capital	Officials' comment
15. Move KiwiSaver to "Exempt-Exempt-Taxed" system	$15.4 billion *Assumes no behavioural change. See KiwiSaver and the Taxation of Retirement Savings (T2019/297, IR 2019/081 refer) for context and assumptions.*	*Distributional impacts:* Measure is regressive and disproportionately benefits those with high income and wealth. *Horizontal equity:* Would benefit those saving through KiwiSaver, but not those in similar schemes or who choose to save through different means. *Integrity:* Would create opportunities to avoid tax.	*Incentives to save and invest:* It is unclear whether tax incentives for savings improve private savings and investment and allocative efficiency. Will likely decrease national savings.	No significant impacts identified	Defers taxation of contributions into future. Ultimate impact on private savings and investment difficult to assess. Will decrease national savings.
16. Move KiwiSaver and similar saving schemes to "Exempt-Exempt-Taxed" system	$24.1 billion *Assumes no behavioural change. Previous report KiwiSaver and the Taxation of Retirement Savings (T2019/297, IR 2019/081 refer) includes context and assumptions.*	*Distributional impacts:* Measure is regressive and disproportionately benefit those with high income and wealth. *Integrity:* Would create opportunities to avoid tax.	*Incentives to save and invest:* It is unclear whether tax incentives for savings improve private savings and investment and allocative efficiency. Will likely decrease national savings.	No significant impacts identified	

Business tax options s s9(2)(f)(iv)

Policy option	Fiscal cost over five years (2021-2026)	Social capital	Financial and physical capital	Human capital	Officials' comment
s9(2)(f)(iv)					

8 s9(2)(f)(iv)

Business tax options, continued

Policy option	Fiscal cost over five years (2021-2026)	Social capital	Financial and physical capital	Human capital	Officials' comment
20. Reduce restrictions on loss carry-forwards when a company is sold	$0.2 billion	s9(2)(f)(iv) [redacted]			
21. Allow deductions for "black-hole" expenditure	$0.1 billion				
s9(2)(f)(iv) [redacted]					

Housing options

	Fiscal cost over				Officials' comment
s9(2)(f)(iv) [redacted]					
25. Remove rental loss ring-fencing	$0.8 billion	*Distributional impacts:* Distributional impacts are not able to be assessed. *Horizontal equity:* Would ensure that investments in buildings are taxed similarly to other investments.	*Distortions to saving and investment decisions:* Improves investment decisions by supporting neutrality of tax system and productivity. *Incentives to save and invest* Would encourage housing supply	No significant impacts identified	Officials support this measure

Appendix B: Summary of fiscal impact of measures across five years

$b	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	Total
Personal income tax reductions							
s9(2)(f)(iv) [redacted]							
Welfare measures							
s9(2)(f)(iv) [redacted]							
Saving measures							
Remove ESCT for contributions to KiwiSaver where employee earns less than $48,000		0.2	0.20	0.2	0.2	0.3	1.1
Remove ESCT for contributions to KiwiSaver where employee earns less than $48,000. Exemption abates at 6 cents per dollar for every dollar earned above $48,000		0.3	0.3	0.3	0.4	0.4	1.7
Increase member tax credit to $0.75 per $1 of contribution		0.5	0.5	0.5	0.5	0.6	2.6
Primary caregiver can receive full member tax credit in year of child's birth regardless of their KiwiSaver contributions		0.01	0.01	0.01	0.01	0.01	0.07
Reduce lower PIE rates by five percentage points for KiwiSaver funds		0.1	0.1	0.1	0.1	0.2	0.6
Move KiwiSaver to "Exempt-Exempt-Taxed" system		2.5	2.8	3.1	3.4	3.7	15.4
Move KiwiSaver and similar saving schemes to "Exempt-Exempt-Taxed" system		4.2	4.5	4.8	5.1	5.4	24.1
Business tax options							
s9(2)(f)(iv) [redacted]							

$b	2020/21	2021/22	2022/23	2023/24	2024/25	2025/26	Total
Reduce restrictions on loss carry-forwards when a company is sold		0.05	0.05	0.05	0.05	0.05	0.2
Allow deductions for “black-hole” expenditure		0.01	0.02	0.02	0.03	0.04	0.1
s9(2)(f)(iv)							
Housing options							
s9(2)(f)(iv)							
Remove rental loss ring-fencing		0.3	0.2	0.1	0.1	0.1	0.8

Note: These costings should be considered as preliminary and indicative. Some costings are being updated to convert to fiscal years, and the measures do not take into account broader macroeconomic impacts and associated flow on fiscal impacts.

Note: Page 29-38 have been removed under section 9(2)(f)(iv) OIA

19.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Reference: T2019/538 SH-13-8

Date: 28 February 2019

To: Minister of Finance (Hon Grant Robertson)

Deadline: None
(if any)

Aide Memoire: KiwiSaver Distributional Scenarios - Taxing Share Gains and TWG Recommendations

This Aide Memoire responds to a request from your office for distributional information that shows how the recommendations in the Tax Working Group (TWG) Final Report will affect the build-up of balances in KiwiSaver accounts, compared to the status quo.

In response to the request, officials have prepared stylised scenarios that can be used for illustrative purposes. These scenarios have been prepared under time pressure and should be interpreted with caution.

Actual KiwiSaver investment returns are likely to differ from the returns assumed in the scenarios. The tax treatment of returns will also differ depending on the form of the returns, under both status quo policy settings and the TWG's recommendations.[1]

A general observation is that for lower income savers, their net benefit increases over time, as the relatively large benefit of the higher member tax credit and lower employer superannuation contribution tax increases compounding investment returns. For higher income savers, the benefits of subsidies to contributions initially give them a net benefit, but over time the higher tax on a larger portfolio of Australasian shares gives them a net cost.

Assumptions

Officials have illustrated stylised investment returns for four hypothetical savers – persons earning $48,000, $62,000, $100,000 and $200,000 per year. For simplicity, they are presumed to earn the same income every year. While assuming no wage growth is not realistic, it is consistent with how officials and the TWG have previously reported on KiwiSaver distributional issues. It also makes the benefits to lower income savers more apparent.

[1] For example, capital gains on Australasian shares, returns on other foreign shares, and returns on debt investments are all taxed in different ways under both status quo policy settings and the TWG's recommendations.

Officials have modelled contributions and earnings over 30 year and 45 year periods. This is similar to distributional analysis of KiwiSaver options that was previously provided to the TWG (which the TWG published in the Interim Report), and that has also been provided to you (T2019/297; IR2019/081 refers).

- **Contributions** – savers are assumed to contribute 3% of their pre-tax income to the fund each year, and their employer is assumed to contribute a matching 3% contribution. Employer superannuation contribution withholding tax (ESCT) is withheld from the matching contribution when applicable. The applicable member tax credit is contributed by the Government.

- **Investments –** 15% of new contributions are invested in Australasian shares, and the remainder are invested in other investments.[2] The portfolio is rebalanced every year to maintain a 15% portfolio allocation in Australasian shares.

- **Investment returns –** Capital gains on Australasian shares are presumed to be 3.7% per year, which is the average annual gain for domestic shares over the last 20 years.[3] Dividends on Australasian shares are assumed to be 5% gross (inclusive of imputation credits). All other investments are presumed to earn a 5% taxable return.

- **Relevant KiwiSaver and tax rules** – the following bullets describe how KiwiSaver and tax settings would change if the TWG's recommendations were adopted, and how these changes would affect different scenarios:

    - **Member tax credit** – the member tax credit is currently a maximum of $521 per year. Under the TWG's recommendations, the member tax credit would change to a maximum of $781.50 per year. *This recommendation affects all scenarios*.

    - **ESCT** – ESCT currently applies to all KiwiSaver employer contributions under a progressive rate schedule. Under the TWG's recommendations, ESCT would be rebated to the fund for persons earning up to $48,000 per year and partially for persons earning above that amount. *This recommendation affects the scenarios for the people earning $48,000 and $62,000.*

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[2] This is the average allocation of investment into Australasian shares according the 2018 KiwiSaver annual report published by the Financial Markets Authority.

[3] For the revenue costing, we assumed 3% annual appreciation in share values. That was chosen out of a principle of conservatism given inherent volatility in share prices. As this aide memoire is illustrating the potential cost to KiwiSavers of taxing the gain, it is conservative to use the higher historical average amount. This will also make it more comparable to analyses in the private sector that are likely to use a similar appreciation assumption.

- **Taxation of investment income** – This is effected through the portfolio investment entity regime, which applies a progressive rate to the investor's share of the fund income. Under the TWG's recommendations, the rates lower than 28% would be reduced by five percentage points each. *This recommendation only affects scenario for the person earning $48,000.*

- **Taxation of capital gains on Australasian shares** – currently, these gains are not taxed. Under the TWG recommendation, these would be taxable like other investment income earned by the fund.[4] *This recommendation affects all scenarios*.

The calculated KiwiSaver balances are set out in the tables in the Annex.

Steve Mack, Principal Advisor, Tax Strategy, s9(2)(a)
Mark Vink, Manager, Tax Strategy, s9(2)(a)

[4] Shares in other foreign companies are taxed under the fair dividend rate and there is not TWG recommendation to change that.

Annex: KiwiSaver balances after 30 years and 45 years

Saver earning $48,000 per year

New Law: Balance after 30 years	$ 249,068	
Old law: Balance after 30 years	$ 207,345	
Difference:	$ 41,723	20%

New Law: Balance after 45 years	$ 589,567	
Old law: Balance after 45 years	$ 481,207	
Difference:	$ 108,360	23%

Saver earning $62,000 per year

New Law: Balance after 30 years	$ 240,500	
Old law: Balance after 30 years	$ 221,088	
Difference:	$ 19,412	9%

New Law: Balance after 45 years	$ 518,969	
Old law: Balance after 45 years	$ 485,439	
Difference:	$ 33,350	7%

Saver earning $100,000

New Law: Balance after 30 years	$ 343,034	
Old law: Balance after 30 years	$ 337,273	
Difference:	$ 5,761	2%

New Law: Balance after 45 years	$ 740,224	
Old law: Balance after 45 years	$ 740,295	
Difference:	$ (71)	0%

Saver $200,000

New Law: Balance after 30 years	$ 640,487	
Old law: Balance after 30 years	$ 643,023	
Difference:	$ (2,536)	0%

New Law: Balance after 45 years	$ 1,382,092	
Old law: Balance after 45 years	$ 1,410,970	
Difference:	$ (28,878)	-2%

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Further advice on potential asset coverage

Date:	4 March 2019	**Priority:**	Medium
Security level:	Sensitive - Budget	**Report number:**	[IR2019/111] [T2019/563]

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	None
Minister of Revenue	**Note** the contents of this report	None

Contact for telephone discussion (if required)

Name	Position	Telephone	
Matt Benge	Chief Economist	s9(2)(a)	
Matt Nolan	Senior Policy Analyst		
Mark Vink	Manager, Tax Strategy, the Treasury		
Steve Mack	Principal Advisor		

4 March 2019

Minister of Finance
Minister of Revenue

Further advice on potential asset coverage

Executive summary

1. The economic and social consequences of the taxation of more capital gains depend on what asset classes are included in the tax. You asked for advice regarding two possible sets of asset coverage:

   - a tax that exempts the taxation of capital gains on corporate assets; and
   - a tax that is only levied on residential rental property (excluding second homes).

2. This report first outlines the consequences of exempting the capital gain on corporate assets from any extension of the taxation of capital gains. This proposal does not appear to match with the Government's broader economic and social objectives and has anomalous consequences.

3. It has been suggested by s9(2)(a) [redacted] that an exemption of the taxation of capital gains on corporate assets could be implemented in the following ways:

   - For listed companies, capital gains earned by the company would not be taxed, but shareholders selling shares in listed companies would be taxed on any gain (this would only apply to resident shareholders).
   - For widely-held unlisted companies (more than 25 shareholders, none owning more than 50%), the same rule would apply as for listed shares except no gain on the sale of shares by shareholders would be taxed unless the shares were acquired after the effective date of the tax (grandparenting).
   - For private/unlisted companies, any gain earned by the company would be attributed to the shareholders and they would have to pay tax on the gain. For the shareholders, they would pay tax on the gain from the sale of shares only if they acquired the shares after the effective date (grandparenting).

4. This approach has been suggested as a solution to three potential issues:

   - **Goodwill valuation**: The difficulty of valuing of business assets, specifically goodwill.
   - **Compliance costs**: The high compliance costs associated with necessary rules for corporates.
   - **Double-taxation and equity market effects**: The potential for double taxation of shareholders, exacerbating instead of solving the differential tax treatment of assets.

5. In our view, the approach is unlikely to be effective in addressing these issues and may create other negative unintended consequences:

   - Such an exemption will do little to deal with the goodwill valuation problem and will only have a limited effect on the double-taxation problem.

- In terms of the reduction in compliance costs, the greater incentive to tax plan to avoid capital gains tax will partially undercut this benefit and may give business an incentive to incorporate in order to take advantage of this tax benefit.

- The method to address tax planning (deeming sales to occur at a shareholder level for closely held companies) would in effect treat small businesses more harshly than large businesses.

6. Insofar as this exemption will include grandparenting of existing assets at valuation day, and leaves the capital gain of non-residents untaxed, it will reduce government revenues and create an unfairness in how the burden of the taxation of more capital gains is shared.

7. The report also outlines the consequences of exempting second homes from a tax on the capital gains on residential property.

8. Exempting second homes does reduce compliance costs and lowers taxation on those who own a vacant second home (eg a bach). However, it also creates compliance and administrative costs associated with the definition of a second home, leads to tax avoidance opportunities to investors in residential property, and may be seen as unfair relative to the treatment of capital gain income from other assets. Such an exclusion will likely restrict the supply of rental property and increase the rents faced by low-income households.

9. Overall, we would recommend against both exclusions. The TWG approach to taxing both corporate and shareholder capital gains is appropriate and fair given that adjustments are made to compensate for double-taxation. The exclusion of second homes from any tax on residential property risks undermining the governments housing related and may be perceived as an unfair concession to those with existing housing wealth.

Recommended action

We recommend that you:

10. **note** the contents of this report.

Noted

s9(2)(k) [redacted]

Mark Vink
Manager,
Tax Strategy, the Treasury

Noted

s9(2)(k) [redacted]

Matt Benge
Chief Economist
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

An exclusion of corporate capital gains from taxation

11. New Zealand's company tax system includes imputation credits for corporate tax paid. This implies that the company tax acts as a withholding tax for shareholders that are New Zealand residents, and a final tax for shareholders that are non-resident. In the absence of company taxation non-resident shareholders would be largely untaxed, and there would be an incentive for domestic residents to accumulate income in companies in order to defer paying tax.

12. For a domestic resident, the New Zealand tax system attempts to tax the individual at the same rate irrespective of their income source. In this way, the income tax base for companies is the same as for individuals.

13. Given this equal treatment of income, and the importance of a withholding corporate tax to limit deferral opportunities, the Tax Working Group (TWG) suggested taxing capital gains at both the shareholder and corporate level – with the corporate taxation of capital gains acting as a withholding tax through the imputation system.

14. Furthermore, the taxation of capital gains at both the shareholder and corporate level is in line with how capital gains are taxed in other countries.

15. Four potential issues with taxing both corporate and shareholder income have been raised: the valuation of goodwill, the compliance and administrative cost, the potential for double taxation, and equity market effects.

- **Goodwill valuation**: Some business assets, specifically goodwill, will be difficult and expensive to value on valuation day.
- **Compliance costs**: The cost of compliance for corporates may be high relative to revenue, especially given necessary rules around double deductions, mergers and demergers, and forms of rollover (eg scrip-for-scrip).
- **Double-taxation**: When shareholders sell shares for a gain in a company with unrealised gains that will be taxed later, or when companies retain earnings, then the tax liability is imposed on existing shareholders as well as the company.
- **Equity market effects**: The introduction of taxation of more capital gains is intended to place assets allocation on a more even playing field. If there is significant double-taxation of corporate investment in New Zealand, then this could lead to a bias against investment in the corporate sector.

16. The introduction of a comprehensive capital gains tax will have **compliance costs,** however whether those costs rise or fall given an exclusion depends on the design. Exclusions encourage tax planning for individuals and business who have the ability to reclassify income. Insofar as more complex rules around enforcement and reporting of income are required to reduce this tax planning this can increase compliance costs. However, removing the need for companies to value assets will reduce compliance costs.

17. In the case of an exclusion of corporate assets, the compliance cost benefits associated with not having to report realised capital gain income will also come with the broader efficiency cost associated with encouraging incorporation of businesses that would – without the tax incentive – be better served by staying unincorporated.

18. It is likely that the **revenue sacrificed** from such an exclusion would be significant. According to data from the Australian Tax Office, in the 2015/16 year companies paid 36% of the tax on capital gains in Australia. Although this exaggerates the long-term revenue loss from such an exclusion – as for domestic residents the tax would eventually be paid at the personal level – this does suggest that there would

be a sizable deferral benefit for companies which reduces the value of tax received by the government. However, to the extent listed companies earning capital gains are owned by non-residents, the foregone revenue will never be recovered.

19. The **equity market effects** problem was raised in the context of **double-taxation,** and the concern that the double-tax issue would disincentivise investing in equity rather than investing in other assets. As a result, both issues are considered together. Data shows that the double-taxation issue is generally not a problem for listed companies, as they regularly distribute imputation credits which shows they are regularly distributing taxed income. For private companies, they can manage their affairs to avoid double tax before the sale of a company. For corporate groups, share cost adjustment rules are being considered to manage double tax (and double loss) issues.

20. The majority of the TWG and the Secretariat were of the view that further special rules (other than those referred to in the paragraph immediately above) were not required to address the double-taxation of unrealised capital gains.

21. However, another solution that was raised by one member of the Tax Working Group s9(2)(a) [redacted] is to only tax capital gains at the shareholder level (on distributions and gains on the sale of shares). s9(2)(a) [redacted]; paper sketching out this solution is attached in Appendix 1 in this report. The Secretariat's initial response to this recommendation is given in Appendix 2.

22. This solution leads to different income tax bases for individuals and corporates and as a result such a solution also requires that the scope of the exclusion is set appropriately (eg including gains to residential rentals held by companies).

23. Such a solution does not solve the problems identified and can create additional issues in the tax system. In order to evaluate this, it is necessary to consider how the exemption of corporate taxation of capital gains would work for both listed and unlisted companies, and for widely and closely-held companies.

Widely-held listed companies

24. For widely-held listed companies it has been suggested that no tax on gains at the company level should be levied, with a tax on distribution to shareholders (including capital gains) and on gains on the sale of shares.

25. An initial valuation of the company on valuation day is provided by the value of shares. As a result, the value of the goodwill of a listed company will be reflected in its share value which will be known on valuation day. Given this the **goodwill valuation** concern is relatively unimportant for listed companies.

26. Exempting capital gains at the corporate level addresses the part of the **double-tax** issue associated with unrealised corporate capital gains.[1] However, this would still double-tax retained earnings.

27. Widely-held companies would benefit (in general) from lower **compliance costs** due to the exclusion of corporate assets from the tax base.

28. Although the benefits from excluding listed companies are small, there are also costs. Non-residents and those with tax exempt status do not pay tax on the capital gain associated with their shares, and as a result would not pay any tax on capital gains. This can be compared with the system proposed by the majority of the TWG, where gains are taxed at the corporate level. Under that system, foreign

[1] That is, from the share price appreciating because the company has assets that have appreciated in value that have not been sold.

shareholders will bear some of the cost of the tax when they hold shares in companies that realise capital gains.

Widely-held unlisted companies

29. The same method of tax (no tax at the company level) has been suggested for widely-held unlisted companies. This will lead to similar effects on **double-taxation** to the situation with a widely-held listed company.

30. The complicating factor is that unlisted companies do not have an initial share price on valuation day to determine company value.

31. Exempting the taxation of corporate capital gains on widely-held unlisted companies does not remove the need to have an initial **valuation of goodwill** to determine the tax liability when a share in the company is sold. As a solution to this problem, Robin Oliver's paper suggests shares in these companies are grandparented.

32. However, the costs associated with grandparenting (limiting the application of the tax to assets acquired after the date of introduction) were already identified as more significant that any valuation issues in the TWG report. In the context of this proposal these issues are:

- **Lock-in:** Grandparenting makes individuals reluctant to sell shares in companies they owned prior to the introduction of the tax, even when there are economically prudent reasons for the sale.
- **Compliance and administrative costs**: Although the asset no longer needs to be valued on the day the tax is introduced, it creates issues regarding when an asset enters the tax base – which require administration to prevent avoidance and additional collection and reporting of information by asset owners. For example, if a company starts to undertake new business and so the company value reflects assets invested in after the introduction of the tax, at what point should their shares no longer be grandparented?
- **Lost revenue**: The combination of lock-in and higher compliance and administrative costs reduce the revenue received from the tax. Australia introduced a capital gains tax in 1985 with grandparenting for existing assets, and there are still assets that have not yet been taxed.
- **Unfairness**: Grandparenting involves taxing two people who are making the same investment decision (to sell a given asset) differently based on the day they purchased the asset.

33. As a result, the goodwill problem is only solved if grandparenting is introduced for shares. This comes with the associated costs of grandparenting, which are likely to be substantially larger than the costs associated with the initial valuation of goodwill.

Closely-held unlisted companies

34. Closely-held companies are companies with few large shareholders such that the ownership and management of the company are performed by the same person. In this case if a company is not taxed on a gain but shareholders are, then a company's owner can hold their personal financial assets in a company and defer the payment of any realised capital gain.

35. As a result, high wealth individuals could use a closely-held company to defer capital gains tax payments on their personal assets, introducing a significant unfairness into the tax system.

36. The solution suggested in s9(2)(a) [redacted] paper for this issue is to force closely-held companies to distribute any realised capital gains in the year they were realised. In essence this involves treating assets as though they were held directly by shareholders.

37. Although this removes the incentive to hold personal assets in a closely-held company, it also treats closely-held companies more harshly than other corporate entities. Due to this treatment, it results in no **compliance cost** benefits to this corporate entity.

38. As in the case of widely-held unlisted companies, the goodwill problem is only solved if grandparenting is introduced for shares with the associated costs.

Summary of the exclusion of corporate capital gains

39. An exclusion of the taxation of corporate capital gains has been suggested on the basis that it will reduce the compliance cost of the taxation of capital gains, remove the problem of finding an initial valuation of goodwill, and prevent double taxation.

40. However, such an exclusion comes with a number of issues:

- It will reduce compliance costs for corporates, but at the cost of lower government revenue.
- It will only remove the issue of valuing goodwill insofar as grandparenting of goodwill is introduced, which comes with revenue and fairness costs.
- It will remove the double-taxation of unrealised gains but not realised earnings. As companies currently manage their affairs to avoid temporary double-taxation, the actual benefit of limit double-taxation appears limited.

41. Overall, the full proposal for excluding corporate capital gains from the income tax base does not appear to satisfy government objectives in terms of the fairness of the tax system.

Excluding the second home from a tax on residential property capital gains

42. Taxing only the gains on residential property (excluding owner-occupied property), instead of a more comprehensive scheme is subject to the same efficiency and fairness trade-off associated with any general exclusion:

- It is less equitable as it treats income sources differently and redistributes less from those with high wealth than those with low wealth.
- It is potentially inefficient if it biases land use away from rental property for tax reasons.
- It involves sacrificing revenue. Taxing only residential property would raise \$2.3bn in the five years to 2025/26 compared to the \$8.3bn raised from a comprehensive scheme.
- It reduces compliance and administrative costs by removing the need for owners of other assets to furnish tax returns. At the same time, it does risk creating compliance and administrative costs due to the need to create a boundary between residential property and other asset classes.

43. Targeting a single asset class (eg residential property) where there are multiple uses for the land the asset is used on is likely to reduce the supply of that specific asset and put upward pressure on rents. In the case of residential property, rents in areas where rental property can be more easily substituted (eg for commercial

or owner-occupied residential activity) will likely increase more when the capital gains tax falls only on residential rental property, rather than on all the potential uses of that land. The increase in residential rents has both a fairness cost (given that renters tend to have lower incomes) and an efficiency cost (as investment has been distorted away from providing appropriate housing services for tax reasons).

44. The view of the TWG, which we agree with, is that the rental pressure and associated efficiency costs from taxing only residential property would be limited. If second homes (eg baches) are also excluded then the size of some of these trade-offs will change as there is now an additional substitution – between holding a housing unit as a rental property or as vacant property.

45. A motivation for excluding second homes is that they make up part of an individual or family's personal property, like their primary residence or jewellery. As personal property is excluded from the suggested extension to the taxation of capital gains there is an argument for considering an exclusion of second homes.

46. The additional economic impact of an exclusion of second homes depends on how second homes are defined. There are a number of issues that would need to be worked through, for example:

- If a residential property has ever been rented out, can it be defined as a second home?
- If so, how long must it have been since it was rented out?
- Does renting out to a family member make the property a second home or a rental property?
- If a rental property is sold to a related party at a below market price, and that house is not rented out, is it now defined as either a owner-occupied or second home?

47. ***The exclusion of a second home will increase rents:*** Once a second home is clearly defined, its tax-exempt status creates a tax incentive to hold property as second homes instead of as rental properties. As a result, depending on the definition the exclusion of second homes can lead to individuals keeping property off the rental market including, in some cases, removing tenants from existing rental properties and leaving them vacant. This would reduce the supply of rental property and increase rents.

48. ***Even without higher rents, such a concession may be perceived as unfair:*** Individuals and families that have a second home for personal use own an asset that is generating income (capital gains) that are untaxed, while other individuals who own a similar asset (a rental property) are taxed on the same income gain.

49. ***The revenue cost could be material***: Current estimates suggest that forgone revenue from the exclusion of second homes would be $360m in the five years to 2025/26, or around 16% of the revenue raised by an extension of the tax on capital gains to non-owner occupied residential property. This is without modelling any behavioural response.

50. ***Depending on the rules it will lead to tax planning and gaming of the system***: Excluding second homes from the income tax base will likely reduce compliance cost for those who own a second home. However, depending on the definition of the second home and the level of enforcement there is a risk that owners property owners where the boundary between a second home and a rental home is unclear will face additional compliance cost.

51. Overall, there are significant negative fairness and efficiency consequences associated with excluding second homes from the income tax base. These concerns are exacerbated by the risk that a second home exclusion will lead to a reduction

in the supply of rental property, reducing the real disposable income of low-income households.

Summary

52. You asked us to evaluate the case for or against two exclusions from an extension of the tax on capital gains:

- excluding corporate capital gains from a comprehensive scheme; and
- excluding second homes in addition to owner-occupied land from a tax on the gains from residential land.

53. Given the costs and benefits of these exclusions in terms of efficiency, compliance, and fairness, we recommend against these two exclusions to the income tax base following an extension of the tax on capital gains.

Appendix 1 – Taxing Share Gains but not Gains Made by Companies – s9(2)(a) paper

54. This note considers some of the detail of an option of not taxing companies on capital gains but instead taxing such gains in the hands of non-corporate shareholders when the shareholders themselves realise the gains whether as a distribution from the company or as gain on the sale of shares. This can be seen as consistent with a broadly-based tax on capital gains but one limited to realisation on the basis that only individuals (and entities such as trustees taxed along the lines of individuals) are the real objective of taxation.

55. Company income is that of the individual shareholders and companies are taxed as in effect a withholding tax on the income earned for shareholders. When a company realises a gain but does not distribute that gain to shareholders and shareholders do not sell the shares, then it can be argued that although the company may have realised a gain the shareholders have not.

56. I note at the outset that a proposal along these lines would be a distinctively different approach than set out in the TWG Interim Report and relative to current law. In the time available this note sets out an outline of an approach – it has not been fully developed or analysed and it follows not consulted on. There is no international precedent as far as I am aware to base this approach on. The issue the option attempts to address

57. The option attempts to address three main issues raise in submissions on the broad extension of capital gains taxation as set out in the Interim Report.

- Concerns re transition as a result of the requirement to value property as at 1/4/21. These concerns are not limited to but focus on businesses and business assets and especially the somewhat nebulous and hard to value concept of "goodwill".
- Concerns regarding the high compliance costs especially regarding companies. The necessary anti-double deduction rules for corporates are seen as having very high compliance costs and in addition complex de-merger, script for script and amalgamation rules seems (based on at least some Australian feedback) to result in relatively little tax collected but high costs.
- Concerns regarding the potential adverse effects of the Interim Report proposals on New Zealand equity markets. This is a range of possible problems from inconsistency of tax treatment individuals and PIEs/KiwiSaver to the double taxation (tax penalty) when shareholders sell shares for a gain in a company with unrealised gains that will later be taxed.

58. What seems clear is that the Interim Report proposal will increase tax on New Zealanders owning shares in New Zealand companies (but not New Zealanders owning shares in foreign companies or foreigners owning shares in New Zealand companies). There has been strong evidence that residential rentals are under-taxed (in terms of reasonable commercial rates of return that are taxed). Some evidence that land in general is taxed (although the case for unfettered roll over for substitute assets seems strong given land prices tend to rise across the board and a person selling land to buy land is having to pay more for the new land and thus can reasonably seen as not realised). There is not much evidence it seems that equity overall is under-taxed at least excluding land rich companies. Put another way there seems to be evidence that under current rules there are tax-induced distortions to investment in land especially residential rentals but not otherwise.

59. This would suggest a more specific extension of capital gains taxation (to say residential rentals) but if there is a perceived need to adopt a more comprehensive

approach the approach outlined below could be explored further. Response -in general

60. Continue taxing companies only on revenue account gains (gains already taxable) with imputation but not otherwise. Then tax shareholders on what is distributed to them (dividends) and their gains on sale. In this way capital gains are taxed once – at the shareholder level when in effect they are realised by the shareholder. The government could still extend the scope of taxed gains – most obviously to residential rentals held by companies. It could also tax the gains on all depreciable assets and if it wanted land (although in my view land needs extensive substitute property roll over as above). The key issue is not to tax hard to value items such as goodwill. This response seems to work most easily with listed or public companies where management and ownership are separated and there is a reasonable market value for the shares for the transition.

Listed/Public companies

61. Could consider wider than just listed on stock exchange provided separation owner/manager, insider trading rules etc. apply and readily available market to value. As above:

- No tax on gains at company level (including share gains). So no tax on goodwill.
- Tax at shareholder level on distributions (including capital gains) and gains on sale of shares.

62. Issue 1 dealt with (ready value can be given to shares). Issue 2 dealt with since no need for complex rules to handle double deductions etc. May still need de-merger rules. Re issue 3 – not taxing at shareholder and company level so no double taxation of unrealised gains in most cases (as now). My preference would be to go further and tax the shareholder under a fair return method at 3.5% (no option to use current value when share price falls). Imputation credits can be used to meet fair return tax. Then relatively simple rules and no under taxation.

Unlisted widely held companies

63. Basically companies that owners cannot treat the corporate assets as in essence their own. Have to take into account minority shareholders and no right to buy them out. Could be "widely held" (25 or more shareholders but that current definition excluded "closely held" which precludes companies where a person and associates hold 50% or more which can be many public companies. Same as listed:

- No tax on gains at company level (including share gains). So no tax on goodwill.
- Tax at shareholder level on distributions (including capital gains) and gains on sale of shares.

64. But then have a problem of valuing the shares. If that is a problem grandparent existing shareholding. Do not in my view need continuity requirement or to deal with asset changes. When shares are sold gains are taxed (or lose grandparenting). I would have no roll over of grandparenting on death or gifting. No tax but new owner takes new value and is then taxed. Company may sell and buy assets (not taxed so in effect roll over relief) but shareholders cannot use this to hold their own property since minority shareholders involved. Problem of fair return method is valuation. Danger also of low value company (low FRR) but labour income – professionals in a company paying little FRR tax.

Other (closely held) companies

65. Issue here seems to be that owner and management can in effect be the same. This seems the most difficult issue to resolve. The problem seems to be that if a company is not taxed on a gain but the shareholder is, the shareholder can hold the property in a company and in effect access rollover relief. A person can put their property into a company. Sell the property (no tax) and repurchase other property or hold cash to invest with no tax. In effect roll over relief for substitute assets when no intention to provide such relief. An example would be holding shares in a company rather than personally. Sell shares for a gain and reinvest. I cannot see any other opportunities this creates but open to suggestions.

66. Could deal with this by requiring closely held companies to distribute the gains on the sale of "taxable property" to be distributed to shareholders in that year. Taxable property is property that is not taxable in the hands of the company but would be taxable if held by an individual but would also exclude CFC active income or interests in active CFCs (for the reasons given in the Interim Report) and that does not for roll over relief and is not grandparented. For this to work there seems to be a need to grandparent at least hard to value business assets such as "goodwill". This is intended to be a targeted anti-avoidance rule and so should be targeted where otherwise a company can be used to access what is in effect rollover relief when that is not the policy intent. It would thus seem appropriate to limit this to portfolio share interests, rental properties and specified other material property gains that need targeting.

67. The suggested approach seems more workable the more there is unrestricted roll over relief for in substitute property. If the policy intent is to have no or very limited in substitute roll over relief (the position it seems of the Working Group) it seems likely that this would result in a tax penalty for operating a business through a company. The requirement to distribute gains to shareholders could be met by an actual distribution (taxable) or a credit to current account – still taxable. Crediting to current accounts means cannot just allocate to the lowest rate taxpayer – the company has a legal debt to that shareholder. Shareholders can agree to turn current accounts into equity if so needed. Note that any gains so required to be distributed would have no imputation credits so company could not distribute taxed earnings in lieu of gains. Also in this case have issue with valuation of shares. If an issue may need to grandparent these shares. Grandparented shares will be taxed on distributions but not gains on sale of shares. Again no continuity requirement is necessary – some shares grandparented others not. Also no need for Australian rules re change in the nature of the asset – shares remain the same although could have

68. Rules that if rights attached to shares materially change (move from no right to distribution to right to distribution) then deemed sale and repurchase of shares. I have also considered LTC etc rules. These are more complex although a lot of the restrictions although much of this seems to be because sale of shares in LTC likely to be untaxed. Most of the issue is the look through treatment which means partnership approach requiring adjustment to the cost basis of all entity property for each owner.

69. In any case the above seems simpler and all that is required and by necessity the LTC rules are only elective. Having looked at this issue it does seem however that the LTC rules could be simplified if share gains are taxed. Assessment None of the above is perfect but it should be compared with the Interim Report which we all presumably agree has imperfections even if supported. Also this is just a cursory look at these issues. My overall assessment is that the problem area is trying to restrict in substitute property roll over relief for property held in closely held companies.

70. This suggests the approach would only be workable with less restrictive roll over relief than the Working Group is now considering. Underlying this approach is that gains should be taxed only when cash or a debt is derived by an individual shareholder. It is argued that this can be seen as consistent with a realisation capital gains tax. There seems to be an inherent contradiction if this approach is adopted but there is restricted in substitute roll over relief for individuals. That policy contradiction leads to the need for rules requiring company gains to be in effect deemed to be distributed to shareholders so we preserve cash realisation only by deeming a non-cash realisation to be a cash realisation which is sophistry.

71. With all these caveats the option does suggest a way of legislating the essence of a reasonably comprehensive taxation of capital gains, raising most of the expected revenue (residential land and shares) while minimising compliance costs and fiscal risks of bringing property into the tax base by way of hard to measure valuations and minimising what seems to be the main on-going compliance costs associated with overseas capital gains tax rules in the corporate area. This is by way of extensive substitute property roll over relief, taxing shareholders and not companies, and grandparenting shares that have no ready market valuation. It is no clear that the complexity justifies such a pragmatic approach but it would provide an option should Ministers need that.

Appendix 2 – Secretariat comment on the idea of exempting capital gains at the corporate level

Introduction

1. The idea of exempting capital gains at the corporate level has been raised as a potential solution to three issues with the Group's main proposal. Those three issues are:
    - It will be costly to come up with a valuation day value for assets like goodwill (**the goodwill valuation issue**)
    - Any rules to deal with double taxation and double deductions will be complicated and perhaps only partially successful (**the double tax issue**)
    - There will be increased taxation of New Zealand equity markets (**the taxing equity issue**)

Analysis

2. New Zealand's company tax system with imputation means the company tax operates largely as a withholding tax for shareholders that are New Zealand residents, and a final tax for shareholders that are non-resident. From a domestic perspective, taxing at the company level removes an artificial advantage (if the alternative is not taxing company income) to earning income through a company instead of individually. In the absence of company taxation there would be a strong incentive to accumulate income in companies and not pay dividends or sell shares so that there would be major tax deferral opportunities.

3. In order to prevent deferral, the income base for companies is the same as for individuals (except for some exceptions owing to the different legal nature of companies).

4. Exempting capital gains for companies while taxing them for individuals would be a major departure from this similar income base approach which prima facie should result in efficiency, fairness, and revenue costs. The justification for suggesting this seems to be that there are significant compliance costs relative to revenues, and that there are risks of double deductions and double taxation from applying capital gains tax at both the company level and the individual level. One particular concern has been whether much capital gains tax revenue will be received from corporate capital gains taxation. Evidence from Australia and other countries shows that companies pay a significant amount of capital gains tax, and officials have done significant analysis to recommend rules to minimise instances of double taxation and double deductions (and the Group is suggesting that the government consider the Australian consolidation approach, in case that would be better). Following are more detailed comments.

5. The exemption would require different rules for listed companies, and for closely and widely held unlisted companies, and so this note addresses both separately.

Widely held listed companies

6. Exempting capital gains at the corporate level addresses part of the **double tax issue**. This leaves taxation of capital gains at the shareholder level, through taxation of dividends and a new shareholder capital gains tax. This would still double tax any retained earnings (although the Secretariat notes that it does not consider this to be a major problem given that data on imputation credit balances suggests that most publicly-listed companies pay out imputation credits quickly).

7. As an initial point, it's worth noting that this proposal would not really address the **taxing equity issue**, except to the extent that it removes any **double tax issue**. Even if capital gains are exempt at the corporate level, investors in New Zealand equities will be taxed on their capital gains.

8. At times there will be difficulties in valuation, when listed companies have to determine a gain from selling a particular business. In the Secretariat's view, this **goodwill valuation issue** for publicly-listed companies is unlikely to be significant enough under the Group's current proposal to justify a departure from the underlying principles of the imputation system.

   The value of the goodwill of the listed company itself will be reflected in its share value which will be known on valuation day. Goodwill is potentially relevant if a listed company sells an operating subsidiary (which will have its own goodwill component). Even so, in the experience of many countries, corporate reorganisation rollovers often mean it is not necessary to know the value of valuation day goodwill, depending on how the sale is structured.

9. The downside of exempting listed companies is unfairness from exempting the largest companies from the tax, and revenue los as it is unlikely the listed company would pay out the income as an unimputed dividend (while listed companies have a high level of distributing imputed dividends, they are much less likely to distribute unimputed dividends), and many shareholders of the listed company would not pay tax when they sell their shares (because they are non-resident or tax exempt).

Widely held unlisted companies

10. Trying to extend the proposal to unlisted companies creates its own issues.

11. Exempting capital gains for widely held unlisted companies would not solve the **goodwill valuation issue** as those companies would still need a starting valuation including goodwill to measure capital gains if their shares are sold. If this is too difficult, then it has been suggested these shares might be grandparented. But that raises all the problems the Group has identified with grandparenting.

Closely held unlisted companies

12. Closely held companies have the same problems as above, but the additional problem that owner-managers will be able to defer the tax by not selling shares nor paying unimputed dividends. As a solution, there might be a requirement to distribute any realised capital gains in the year they were realised unless rollover treatment were available. In effect though, this means harsher treatment for closely held companies than listed companies, unless there is generous rollover. In effect, closely held companies are treated as though their assets were held directly by their shareholders, and hence not eligible for the proposed exemption from capital gains tax for companies. It also means there is no compliance cost/simplicity benefit for these companies if the capital gain income must be distributed because it means the capital gain income must still be calculated.

Summary and conclusion

13. In summary, the option would grandparent goodwill and unlisted shares, and either:
    - Provide extensive rollover for closely held companies
    - Deem distributions of capital gains realised at the corporate level for closely held companies.

14. It would not completely resolve any double tax issues, and would still tax investors on their equity gains. In terms of goodwill valuation issues:

    (a) in the relatively limited circumstance of a sale by a listed group of a business line there should be no issue (no need to value goodwill because sale not taxable); and
    (b) in relation to a sale by a non-listed widely held group of a business, goodwill valuation issues would be resolved only if the shares in the holding company are grandparented.

15. In the secretariat's view, the option outlined is inferior to the main proposal developed by the Group. It would also reduce revenue (to the extent a company is owned by non-residents or tax-exempt shareholders, tax would not be paid even if a dividend is paid or the shareholder sells their shares) and raise equity and integrity concerns if companies are exempt from the tax while individuals must comply.

	Public companies	Widely held unlisted companies	Closely held companies
Goodwill valuation issue	Unlikely to be a major issue under current Group proposal	If it resolves, it only does so through grandparenting	If it resolves, it only does so through grandparenting
Double tax issue	Partially resolves (still have double tax of retained earnings)	Partially resolves (still have double tax of retained earnings)	Double tax n (manageable if closely held). Solves double deduction problem.
Taxing equity issue	Doesn't resolve	Doesn't resolve	Doesn't resolve
Other points	Likely to result in revenue loss	May require grandparenting of existing businesses	May require grandparenting of existing businesses

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Capital Gains and Labour Income

Date:	4 March 2019	**Priority:**	Medium
Security level:	Sensitive	**Report number:**	IR2019/116 T2019/558

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	None
Minister of Revenue	**Note** the contents of this report	None

Contact for telephone discussion (if required)

Name	Position	Telephone
Matt Benge	Chief Economist, Policy and Strategy, Inland Revenue	s9(2)(a)
Mark Vink	Manager, Tax Strategy, the Treasury	

4 March 2019

Minister of Finance
Minister of Revenue

Capital Gains and Labour Income

Executive summary

This paper responds to the issue raised in public commentary of whether it makes sense to tax returns from entrepreneurship at the same rate as other income.

This is a noting report. We discuss, by way of examples, how taxing capital gains can reduce incentives for entrepreneurial effort but only to the same extent as an income tax reduces work incentives more generally. Attempting to tax gains as neutrally as possible is aimed at promoting fairness and efficiency by ensuring that all forms of income are taxed as even-handedly as possible. Concerns that taxing capital gains will reduce entrepreneurial effort or investment can be addressed by other neutrality-enhancing measures such as reinstating building depreciation and addressing loss carryforwards and blackhole expenditure.

Recommended action

We recommend that you **note** the contents of this report.

Noted	Noted
Mark Vink Manager Tax Strategy, The Treasury	**Matt Benge** Chief Economist Policy and Strategy, Inland Revenue
Hon Grant Robertson Minister of Finance / /2019	**Hon Stuart Nash** Minister of Revenue / /2019

Purpose

1. Capital gains may at times be a reward for the labour effort or business acumen of the owners of a business. Also capital gains may reflect compensation to the owners of a business for taking on risk. The aim of this note is to explore, through illustrations, whether these considerations provide grounds for not taxing capital gains or for taxing capital gains at concessional rates in order not to discourage entrepreneurial effort.

Background

2. Some media commentators have raised the question of whether it makes sense to tax returns from entrepreneurship at the same rate as other income. This note provides advice on the issue.

Discussion

3. Under New Zealand's tax settings we attempt to tax a very broad definition of income as neutrally as possible. Generally employees are taxed on their salaries and wages when they are paid. These salaries and wages will reflect a reward for people undertaking jobs that may be more or less arduous and working in occupations which may be more or less risky.

4. If capital gains are not taxed, not only will some forms of capital income be untaxed, there will also be scope for certain forms of labour income to escape taxation. Both of these situations raise fairness and efficiency concerns.

Example 1 – Do-it-yourself improvements

5. Consider an individual who buys a house for $400,000, through their own efforts makes improvements to the house (e.g., repairs, recarpeting, painting) and who a short time later sells the house for $600,000. Much of any gain (over and above the cost of material used in making the improvements and transactions costs in buying and selling the property) will reflect compensation for the individual's efforts as well as profits from having the business acumen to see that this was a profitable opportunity. If this gain is not taxed, the treatment of labour income is not horizontally equitable and this provides incentives for people to undertake this sort of activity even when they would prefer to take a paid job in the absence of tax considerations. The fact that salaries and wages are taxed while capital gains are not provides a tax bias encouraging them to earn tax-free capital gains rather than undertaking paid employment where income is taxed. Here the absence of a tax on capital gains can end up being both unfair and economically inefficient. (Of course, if the person had the intention of profiting from undertaking this activity, the gain would be taxable. However, intention is difficult to prove and often the gain may end up not being taxed).

Example 2 – Sweat equity

6. Consider an entrepreneur who is prepared to accept a low or even negative cash income from a business in early years in order to build up goodwill in a business and later sell the business for a profit. For example, consider a restaurant proprietor who is willing to accept a low cash income from the restaurant of $40,000 per annum in order to build up a loyal clientele. The build-up of the loyal clientele adds $60,000 per annum to the value of the business and after five years the restaurant proprietor is able to sell the restaurant for a $300,000 gain. Much of this gain will reflect compensation for the labour efforts and business acumen of the owner of

the business. If these gains are not taxed, there will be a bias favouring this sort of activity over undertaking paid employment where income is taxed, or establishing a business where more of the rewards arise as currently taxed income and less arise as capital gains. A tax on capital gains would reduce these biases. It would also make the tax system fairer by making the tax treatment of different forms of income more consistent.

7. It might perhaps be argued that those setting up a business are at times doing something more valuable for society than they would be if they took a job as a salary and wage earner. By setting up a business people may create jobs for others or come out with entrepreneurial ideas leading to wider social benefits. This is no doubt true but any wider benefits to society are unlikely to be closely associated with whether gains from a business are likely to be accruing as capital gains or as income that is taxed. Many people in paid employment also contribute much to wider society while still paying tax on their income. It seems very difficult to adjust taxes to take account of the broader benefits to society of people working in different ways.

8. Our recommended approach to generally tax all forms of income as neutrally as possible reflects the sheer impossibility of working out when specific activities provide wider social benefits justifying a government subsidy.

Example 3 - Risk

9. Consider the case where a taxpayer chooses between two options:

- Earning a salary of $100,000 ($100,000 expected value)
- Forgoing a salary, but trying to create a business that might be worthless (90% chance) or end up being sold for $1m capital gain (10% chance). This option generates $100,000 of expected value.

10. If there were no tax, and a taxpayer was risk-neutral, the taxpayer would be indifferent between the two situations.

11. Now suppose we introduce an income tax (but not tax capital gains) at 30%. The choices are:

- Earn a salary of $70,000 post tax ($70,000 expected value)
- Forgo a salary but try to create a business that might be worthless (90% chance) or end up being sold for $1m capital gain (10% chance) with $100,000 of expected value.

12. By introducing an income tax we have reduced the incentive to work to earn a salary, but maintained the incentive to create a business.

13. If instead we start taxing capital gains, also at 30%, the choices are:

- Earn a salary of $70,000 post tax ($70,000 expected value)
- Forgoing a salary, but trying to create a business that might be worthless (90% chance) or end up being sold for $1m capital gain that is taxable at 30% (10% chance). ($70,000 expected value).

14. By introducing a broader tax on capital gains, we do reduce the incentive to start a business. However, this is only to the same degree that we reduce the incentive to work by taxing salary and wages. Introducing a broader tax on capital gains would

help remove the current bias towards people working to make a capital gain rather than working in paid employment.[1]

Concluding comments

15. The three examples we have provided show how taxing capital gains can reduce incentives for entrepreneurial effort but only to the same extent as an income tax can reduce work incentives more generally. Attempting to tax gains as neutrally as possible reflects the basic idea that "a buck is a buck" and it is fair and efficient to attempt to tax all forms of income as even-handedly as possible. Concerns that taxing capital gains will reduce entrepreneurial effort or investment can be addressed by other neutrality-enhancing measures such as reinstating building depreciation and addressing loss carryforwards and blackhole expenditure.

[1] It is worth noting that even though taxing capital gains will impact on entrepreneurs, there have been a number of leading international entrepreneurs who have advocated taxing capital gains. For example, Warren Buffet and Bill Gates have expressed concerns about the fairness of them not being taxed on the capital gains they derive when many on much lower incomes are taxed at higher rates on their income.

THE TREASURY
Kaitohutohu Kaupapa Rawa

Treasury Report: Treasury Report: Further information on fiscal impacts of potential tax reform options

Date:	4 March 2019	Report No:	T2019/512
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Refer** this report to Minister of Revenue **Discuss** fiscal parameters of tax reform package at Joint Ministers meeting on 5 March.	Prior to meeting with Minister of Revenue at 4.15pm on Tuesday 5 March.

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Oscar Parkyn	Principal Advisor	s9(2)(a)	✓
Mark Vink	Manager		

Actions for the Minister's Office Staff (if required)

Refer a copy of this report to the Minister of Revenue.

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Treasury Report: Treasury Report: Further information on fiscal impacts of potential tax reform options

Executive Summary

This report provides information on the fiscal impacts of tax reform. The paper includes:

- Indicative estimates of potential fiscal headroom for revenue-negative or spending measures over the medium term; and
- Indicative estimates of the impact of different potential tax packages on net core Crown debt, operating balance before gains and losses, and core Crown tax revenue.

The estimates in this report should be interpreted with caution. They are partly based on HYEFU assumptions, and will be superseded by subsequent reporting. The preliminary Budget forecasts will be finalised on 15 March, and the Treasury will provide advice on the fiscal strategy and fiscal targets on 20 March.

The size of fiscal headroom will depend on the fiscal outlook and the fiscal strategy…

The fiscal headroom for a tax package and potential future spending initiatives will depend on the updated fiscal outlook and the Government's fiscal strategy, particularly beyond 2021/22.

We have calculated (on an indicative basis) the headroom that is available for tax reductions or higher spending through to 2025/26. For illustrative purposes, this analysis assumes that net debt is maintained at around 20% of GDP from 2021/22 and that personal income tax thresholds are not adjusted to account for fiscal drag.

Any changes to Budget 2019 operating and capital packages will also affect fiscal headroom. Our estimates are based on the HYEFU budget allowances.

…and require a consideration of wider macroeconomic impacts.

Using fiscal headroom for tax reductions or higher spending will require consideration of wider macroeconomic impacts. Macroeconomic considerations include:

- Managing fiscal risk – ensuring there is sufficient resilience to manage future shocks; and
- Managing the economic cycle – a significant fiscal impulse would impact on the economic outlook, and could lead to higher interest and exchange rates than otherwise.

The estimates are subject to uncertainty, but suggest some headroom is available…

Given current information about the fiscal outlook, and subject to our assumptions, some headroom is available from 2022/23. Nevertheless, the fiscal outlook is highly uncertain. Extending the taxation of capital income would provide additional fiscal headroom.

For illustrative purposes, we show the fiscal impacts of packages that include capital gains taxation s9(2)(f)(iv) [redacted].

- s9(2)(f)(iv) [redacted]

s9(2)(f)(iv) [redacted]

The impacts will also depend on other elements of tax reform, including any business tax and KiwiSaver measures.

…yet there will be trade-offs involved in using headroom for tax packages

s9(2)(f)(iv) [redacted]

Recommended Action

We recommend that you:

a **refer** this report to the Minister of Revenue

Refer/not referred.

b **discuss** fiscal parameters for tax reform at Joint Ministers on 5 March.

Agree/disagree.

Mark Vink
Manager, Tax Strategy

Hon Grant Robertson
Minister of Finance

Treasury Report: Treasury Report: Further information on fiscal impacts of potential tax reform options

Purpose of Report

1. This report responds to your request for further information on the:
   - Indicative estimates of potential fiscal headroom for revenue-negative or spending measures over the medium term; and
   - Impact of different potential tax packages on net core Crown debt, operating balance before gains and losses, and core Crown tax revenue.
2. You also requested further information on distributional impacts of potential packages. This will be provided to you in a later report.

Fiscal headroom

Fiscal headroom depends on the fiscal outlook and fiscal strategy

3. The fiscal headroom for a tax package and potential future initiatives will depend on the updated fiscal outlook and the Government's fiscal strategy, particularly beyond 2021/22. The preliminary Budget fiscal forecasts will be finalised on 15 March. The Treasury will provide advice on the fiscal strategy and fiscal targets on 20 March.

Indicative estimates of fiscal headroom depend on assumptions

4. To assist your thinking about the potential fiscal parameters of a tax package, we have calculated indicative amounts of fiscal headroom to 2025/26. The calculation of fiscal headroom is the amount of new spending or revenue reduction that could be consistent with your fiscal strategy.

5. The calculation of fiscal headroom depends on assumptions about government policy and the path of net debt, which requires judgments about the size of fiscal buffers for future pressures and shocks.

6. You have received advice on potential operating and capital packages for Budget 2019 [T2019/359]. Decisions on the Budget 2019 package will impact on the degree of fiscal headroom available. There will be less fiscal headroom if the Budget 2019 package is higher than the allowance assumed in HYEFU.

However, there are broader macroeconomic considerations for the use of any fiscal headroom

7. The use of any fiscal headroom for tax reductions or higher spending firstly requires a judgment about whether there are other measures that could better enhance wellbeing or alternatively whether it is better to maintain a greater buffer for future opportunities and pressures on the public finances.

8. Macroeconomic considerations in using fiscal headroom for tax reductions or higher spending are:
   - **Managing fiscal risk** – ensuring there is sufficient resilience to manage future shocks as the fiscal outlook is uncertain; and

- **Managing the economic cycle** – a significant fiscal impulse would impact on the economic outlook, and could lead to higher interest and exchange rates than otherwise.

9. In order to manage fiscal risk, it will be important that policy commitments are consistent with the Government's fiscal strategy and keeping debt at prudent levels. A buffer would enable debt to rise following a recession or natural disaster. It may be particularly important for fiscal policy to help stabilise the economy in a recession, given limited room for the Reserve Bank to cut interest rates.

10. Using fiscal headroom by substantially increasing spending or reducing revenue would have implications for the economic outlook. The effects of any fiscal impulse will depend on the state of the economic cycle and the size and composition of any policy change. Macroeconomic effects would have tax revenue implications, which has not been modelled in our calculations of fiscal headroom.

11. A large fiscal impulse would be expected to increase aggregate spending in the economy, which would create additional inflationary pressure in an already capacity-constrained economy. Therefore, a large fiscal impulse would be expected to lead to the Reserve Bank setting the Official Cash Rate higher than otherwise, which would place upward pressure on the exchange rate at the margin.

12. The above macroeconomic considerations will be addressed in the Treasury's advice on fiscal strategy and long-term fiscal targets on 20 March.

Indicative estimates of fiscal headroom assume the operating and capital allowances in HYEFU 2018…

13. Budget operating and capital allowances provide fiscal headroom for new operating and capital initiatives. In this analysis, we keep the HYEFU 2018 assumptions for Budget allowances (see Table 1). Therefore, the analysis assumes that current and future Budget operating and capital packages can be met from these allowances. However, there are significant pressures on the allowances.

Table 1: Operating and capital allowance assumptions (HYEFU 2018)

$ billion	Forecast period				Projection assumption		
Budget	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**
Operating Allowance	2.4	2.4	2.4	2.4	2.6	2.7	2.8
Capital Allowance	13.1 (multi-year envelope)				6.6	6.9	7.2

14. The degree of headroom could be greater if the Government raised tax revenue (eg, by extending the taxation of capital gains) or was comfortable with higher public debt than currently projected (eg, by maintaining net debt at 20% of GDP from 2021/22).

15. Preliminary Budget fiscal forecasts will be finalised on 15 March. The Treasury has updated its macroeconomic and tax forecasts [T2019/381 refers]. These macroeconomic and tax forecasts have been used to provide an early, indicative forecast of net debt over the forecast period. This is subject to change once preliminary fiscal forecasts are finalised on 15 March. The early, indicative forecasts suggest that net debt is expected to be below 20% of GDP from 2021/22, in line with the Budget Responsibility Rules (Table 2).

Table 2: Net debt outlook with no changes to tax settings (with HYEFU 2018 allowances)

	Forecast horizon					Projection horizon		
Fiscal year	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**
Net debt (% of GDP)	21.0%	20.9%	20.4%	19.5%	18.0%	16.6%	15.2%	14.1%

…and assume net debt is maintained at 20% of GDP…

16. As an indicative assumption for the analysis, we have taken the Budget Responsibility Rule that net debt should not exceed 20% of GDP 2021/22, and calculated headroom to ensure net debt is stabilised at this level beyond 2021/22.

17. For the purposes of illustrating potential fiscal headroom, we make the following modelling assumptions:

- The forecast base uses the preliminary Budget 2019 economic, tax and benefit forecasts, with other fiscal forecasts based on HYEFU 2018;
- HYEFU 2018 operating and capital allowance assumptions;
- Personal income tax thresholds are left unchanged in the projection period, so that fiscal drag leads to higher revenue as a percentage of GDP in the projection period; and
- Core Crown net debt is maintained at around 20% of GDP from 2021/22 to 2025/26.

Box 1: Fiscal drag assumptions

The fiscal headroom calculations assume fiscal drag continues into the projection period (T2019/341 refers), ie that current legislated policy settings remain unchanged over the projection period. This assumption causes tax revenue to rise as a percentage of GDP and differs from the standard technical assumption used in the Government's fiscal projections (beyond the forecast horizon).The Government's fiscal projections, published in the 2018 *Fiscal Strategy Report,* assume that tax revenue remains at a stable percentage of GDP. Therefore, this analysis indicates considerably more fiscal headroom than if tax revenue is assumed to remain at a stable percentage of GDP.

Projection assumptions for the Government's 2019 *Fiscal Strategy Report* will need to be further considered following Budget 2019 policy decisions in April.

…and consider revenue-raising options in the Tax Working Group's report…

18. Tables 3-5 show the amount of fiscal headroom under three tax policy scenarios:

- Status quo: no change to tax policy;
- Comprehensive extension of capital gains taxation (excluding the family home); and
- Extension of capital gains taxation to residential investment property and second homes.

19. Under the status quo, the additional headroom for higher expenses or revenue reduction is around $1.9 billion in 2021/22 and around $4.9 billion in 2022/23 and subsequent years (Table 3). This indicates the amount of additional spending or revenue reduction, in addition to operating and capital allowances, consistent with keeping net debt at around 20% of GDP.

Table 3: Fiscal headroom to stabilise net debt under status quo (in addition to HYEFU 2018 allowances)

Fiscal year	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**5 year total**
Status quo: Headroom for additional operating expenses or revenue reduction ($ billion)	**-**	**-**	**-**	**1.9**	**4.9**	**4.9**	**4.9**	**4.9**	**21.5**
Net debt (% of GDP)	21.0%	20.9%	20.4%	20.0%	20.0%	19.8%	19.7%	19.7%	

20. If revenue was raised with a comprehensive extension of capital gains taxation (majority recommendation of Tax Working Group), the additional headroom for higher expenses or revenue reduction is $2.4 billion in 2021/22, $5.9 billion in 2022/23 and builds up in subsequent years (Table 4).

Table 4: Fiscal headroom to stabilise net debt with comprehensive taxation of capital gains (in addition to HYEFU 2018 allowances)

	Forecast horizon					**Projection horizon**			
Fiscal year	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**5 year total**
Status quo: headroom for additional operating expenses or revenue reduction ($ billion)	-	-	-	1.9	4.9	4.9	4.9	4.9	21.5
Additional revenue from comprehensive taxation of capital gains ($ billion)	-	-	-	0.5	1.0	1.7	2.3	2.8	8.3
Total headroom under comprehensive taxation of capital gains ($ billion)	**-**	**-**	**-**	**2.4**	**5.9**	**6.6**	**7.3**	**8.1**	**30**
Net debt (% of GDP)	21.0%	20.9%	20.4%	20.0%	20.0%	19.8%	19.8%	19.9%	

21. If revenue was raised with an extension of capital gains taxation to residential investment property and second homes, the additional headroom for higher expenses or revenue reduction is $1.9 billion in 2021/22, $5.1 billion in 2022/23 and slightly higher in subsequent years (Table 5).

Table 5: Fiscal headroom to stabilise net debt with taxation of capital gains from residential property (in addition to HYEFU 2018 allowances)

	Forecast horizon					**Projection horizon**			
Fiscal year	**2018/19**	**2019/20**	**2020/21**	**2021/22**	**2022/23**	**2023/24**	**2024/25**	**2025/26**	**5 year total**
Status quo: headroom for additional operating expenses or revenue reduction ($ billion)	-	-	-	1.9	4.9	4.9	4.9	4.9	21.5
Additional revenue from taxation of capital gains on residential investment property and second homes ($ billion)	-	-	-	0.0	0.2	0.4	0.7	1.0	2.3
Total headroom under taxation of capital gains on residential investment property and second homes ($ billion)	**-**	**-**	**-**	**1.9**	**5.1**	**5.4**	**5.7**	**6.0**	**24**
Net debt (% of GDP)	21.0%	20.9%	20.4%	20.0%	20.0%	19.8%	19.7%	19.8%	

Potential packages

The fiscal impact of packages depend on your choices on revenue raisers and revenue-negative options

s9(2)(f)(iv)

[redacted]

Note: Revenue estimates are preliminary and indicative and may change following further refinement or incorporation of macroeconomic effects.

Excluding second homes from capital gains taxation will decrease revenue

23. You requested further information on the fiscal impact of excluding second homes (including baches). Over five years, the estimated foregone revenue due to excluding second homes is approximately $360 million. This is slightly less than that reported to you previously, as the estimate has been converted to fiscal years. We are reporting to you separately on this issue (IR 2019/111, TSY 2019/563 refer).

There is fiscal headroom available for revenue-negative tax packages depending on your objectives and other Budget 2019 decisions

24. Broadly there is potential fiscal headroom for these indicative packages from 2022/23. However, there is minimal headroom for revenue-negative impacts in 2021/22 in order to meet the Budget Responsibility Rules. [redacted] s9(2)(f)(iv)

25. The degree of headroom will also depend on updated fiscal forecasts and on other Budget 2019 decisions. If the Budget 2019 package ends up higher than what was assumed at HYEFU, this would also reduce headroom.

These packages will reduce your headroom for other spending measures or debt reduction

26. The packages outlined in Table 6 would reduce the fiscal headroom for other spending measures or debt reduction. Over the five years to 2025/26:

s9(2)(f)(iv)

[redacted]

Next steps

28. We recommend you refer this paper to the Minister of Revenue and discuss fiscal parameters for tax reform at the Joint Ministers meeting on 5 March.

[1] Estimates are indicative only.

Annex: Impact of packages on key fiscal indicators

29. Figures 7-18 below provide preliminary modelling of the impact on the Government's fiscal position of the 6 illustrative packages. These update those provided in our previous report (*Options for building a package of tax reform, T2019/341, IRD 2019/103 refer)* and reflect the preliminary Budget 2019 economic, tax, and benefit forecasts.

30. Similar to the previous report, these indicate that all packages are consistent with the maintenance of operating surpluses. However, the packages risk the achievement of the net debt target. In addition, there are broader macroeconomic considerations for the use of any fiscal headroom which are considered in paragraphs 7-12 of this report.

s9(2)(f)(iv)

Note: Pages 11 to 17 have been removed under section 9(2)(f)(iv) OIA

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Table – Tax Working Group recommendations

Date:	6 March 2019	**Report No:**	T2019/610 IR2019/128
		File Number:	

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Read** before your meeting on 7 March	Thursday 7 March
Minister of Revenue (Hon Stuart Nash)	**Read** before your meeting on 7 March	Thursday 7 March

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Jordan Ward	Team Leader, The Treasury	s9(2)(a)	
Emma Grigg	Policy Director, Inland Revenue		✓

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury

Note any feedback on the quality of the report	

Enclosure: No

Tax Policy Report: Table – Tax Working Group recommendations

1. We understand that you are meeting on Thursday 7 March to discuss options for a package of tax reform.

2. In order to support that discussion, attached to this report is a table containing the 99 recommendations made by the Tax Working Group (TWG) in their Final Report. This is the same table we provided to you on 14 February (T2019/243, IR2019/062 refers), however, we have included the revenue impacts for each recommendation (if known). If the revenue impact has not been determined, the general impact has been provided.

3. We have also included a column for you to provide comments if you so desire.

4. The revenue impacts of the recommendations that could be considered for inclusion in a mid-year package of tax reform are provided in the joint report, *Information on revenue-negative tax measures* (T2019/616 refers).

Recommended Action

We recommend that you:

a **Read** this report before your meeting on Thursday 7 March.

Jordan Ward **Team Leader** **The Treasury**	Emma Grigg **Policy Director** **Inland Revenue**
Hon Grant Robertson **Minister of Finance** / /2019	Hon Stuart Nash **Minister of Revenue** / /2019

RECOMMENDATIONS OF THE TAX WORKING GROUP

The table below lists all 99 recommendations in the Tax Working Group's Final Report, with the following columns:

- **Status:** Indicates the status of the recommendation as per the table key below.
- **Officials' comment:** Officials' views are provided on an on-exceptions basis (for example, where officials have a different view to the TWG). This reflects officials advice provided to the Tax Working Group. Supporting analysis is typically contained in relevant Secretariat papers. We have also noted where you have already received advice relating to the recommendation, as well as links to other work programmes.
- **Revenue impact:** Indication of revenue impact. Note that the revenue impact for many of the recommendations has not been determined and therefore only general impacts are given (excludes administrative costs).
- **Comment:** Space for you to indicate if you would like to receive further advice on particular recommendations or would like to make a comment.

Table key:

No further work (NFW)	A decision has been made and/or no further work is required.
Work underway (WU)	Work is already underway in the Treasury/Inland Revenue or another agency.
Mid-year package (MYP)	Could be considered for inclusion in a mid-year package announcement.
Work programme (WP)	Could be considered for the Tax Policy Work Programme (a refresh is scheduled for mid-2019)/other agency work programme and/or require further advice

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
Extension of Capital Gains					
1	The majority of the TWG recommends a broad extension of the taxation of capital gains.	MYP	See *Tax Working Group final report – officials' companion advice* (T2019/113, IR2019/041 refers).	**Revenue positive, $8.3 billion**	
2	If a broad extension of capital gains taxation was adopted, the TWG recommends that it have the characteristics detailed in Volume II of their report.	MYP			
Capital and wealth					
3	Do not introduce a wealth tax.	NFW	In responding to the Interim Report, the Government confirmed it is comfortable that no further work is undertaken on wealth and land taxes.	**N/A**	
4	Do not introduce a land tax.	NFW		**N/A**	
Environmental and ecological outcomes					
5	Adopt the TWG's framework for taxing negative environmental externalities.	WP		**N/A**	
6-8	***Greenhouse gases*** a) Support for a reformed Emissions Trading Scheme (ETS) as the centrepiece of emissions reduction efforts, but there should be greater guidance on price and auctioning emission units to raise revenue. b) Periodic reviews of the ETS to ensure it is fit for purpose. c) Emissions should face a price, including from agriculture, either from ETS or a complementary system.	WU	ETS reforms are currently being considered as part of the Climate Change Response Act Amendment Bill. The Interim Climate Change Committee (ICCC) is considering the treatment of agricultural emissions in the ETS and will make a decision by April 2019.	**Revenue positive,** but depends on the design of any changes.	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
9-11	***Water abstraction and water pollution*** a) Tax instruments could be considered to address water pollution and water abstraction challenges. b) Further develop tools to estimate diffuse water pollution. c) Introduce input-based tax instruments, including on fertiliser, if significant progress is not made in the near term on output-based approaches.	WU	The Water Taskforce is working to achieve improvements in water quality as well as efficient and fair allocation of freshwater and nutrient discharges. Initial consultation on discharge approaches is expected in mid-2019.	**Revenue positive,** but depends on the design of any tax instrument.	
12-15	***Solid waste*** a) Supports the Ministry for the Environment's review of the rate and coverage of the Waste Disposal Levy. b) Expand the coverage of the Waste Disposal Levy. c) Reassess the negative externalities associated with landfill disposal in New Zealand to ascertain if a higher levy is appropriate. d) Review hypothecation of the Waste Disposal Levy to ensure funds are being used in the most effective way to move towards a more circular economy.	WU	The Ministry for the Environment is currently reviewing the Waste Disposal Levy and is due to report to Ministers by October 2019. In respect of (d), officials consider the use of funds should not be restricted to circular economy initiatives.	**Revenue positive**, but the impact depends on decisions on the rate of the levy.	
16	***Transport*** Supports current reviews by the Government and Auckland Council into introducing congestion pricing.	WU	The Congestion Question project's Phase II report is due to Ministers mid-2019.	**Revenue positive**, but has not yet been quantified.	
Concessions					
17	Costs associated with the care of land subject to a QEII covenant or Ngā Whenua Rāhui be tax deductible.	WP	If this measure was to progress, the concession should not be overly broad such that it would allow deductions for expenses that have no connection to a business or other taxable activity.	**Potentially revenue negative,** but likely to be minor.	
18	Consider an FBT exemption for public transport.	WP	Officials would need to analyse the benefits of having an exemption for public transport, versus the integrity and fiscal costs. Incentives for purchasing electric vehicles is being progressed as a Budget 2019 bid.	**Revenue negative** to the extent businesses pay FBT now on public transport, impact expected to be minor.	
19	Review various tax provisions specific to farming, forestry and petroleum mining with a view to removing concessions harmful to natural capital, while also considering new concessions that could enhance natural capital.	WP		Depends on the results of the review.	
Other environmental recommendations					
20	Recycle some or all of the revenue raised by environmental taxes into measures that support the transition to a more sustainable economy.	WP	Officials do not recommend strict hypothecation. Recycling revenue raised by auctioning is an option being considered as part of reforms to the ETS. Revenue recycling already occurs with the Waste Disposal Levy.	Could offset revenue positive impacts of environmental changes described above.	
21	Over the longer term, consider an environmental footprint tax or a natural capital enhancement tax.	WP		**Revenue positive**, but the impact depends on the design and level of any tax.	
22	The Government should strengthen its environmental tax capabilities, including with the Parliamentary Commissioner for the Environment.	WP		**N/A**	
23	Commission incidence studies on environmental taxes.	WU	The assessments of distributional impacts of environmental taxes can be carried out as part of consideration of specific environmental tax initiatives.	**N/A**	
24	Undertake further work to assess how taxes can complement other environmental policy measures and to work through the design principles in the TWG's framework for taxing negative environmental externalities.	WP		**N/A**	
The taxation of business					

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
25	Retain the imputation system.	NFW		**N/A**	
26	Do not reduce the company tax rate at the present time.	NFW		**N/A**	
27	Do not introduce a progressive company tax.	NFW		**N/A**	
28	Do not introduce an alternative basis of taxation for smaller businesses, such as a cash flow or turnover taxes.	NFW		**N/A**	
29	Retain the 17.5% rate for Māori authorities.	NFW		**N/A**	
30	Extend the 17.5% rate to the subsidiaries of Māori authorities.	WP		**Revenue negative,** but has not been quantified.	
31	Consider technical refinements to the Māori authority rules, as suggested by submitters, in the Tax Policy Work Programme.	WP		**Unknown**	
32	Change the loss continuity rules to support the growth of innovative start-up firms.	MYP	See *Tax Working Group final report – officials' companion advice* (T2019/113, IR2019/041 refers).	**Revenue negative, $0.2b**	
33	Reform the treatment of black-hole expenditure by spreading such expenditure over five years with a $10,000 safe-harbour threshold of upfront deducts for feasibility expenditure.	MYP		**Revenue negative, $0.1b**	
34	Consider restoring depreciation deductions for buildings if there is an extension of the taxation of capital gains (subject to fiscal constraints). To manage the fiscal costs, the Government could reinstate building depreciation on a partial basis for: a) seismic strengthening only; b) multi-unit residential buildings; or c) industrial, commercial, and multi-unit residential buildings.	MYP		**Revenue negative** Depreciation for: • commercial buildings (1% dv rate), **revenue negative** s9(2)(f)(iv) • industrial buildings (1% dv rate), **revenue negative** s9(2)(f)(iv) • multi-unit residential buildings (1%dv rate), **revenue negative** s9(2)(f)(iv) • seismic strengthening (up to 67% of new building standard, 30 year straight-line deductions), **revenue negative** s9(2)(f)(iv)	
35	Consider tax measures that encourage building to higher environmental standards.	WP	Officials' do not support these measures.	**Revenue negative** could be significant but depends on the design of any tax measures.	
36	Consider developing a regime that encourages investment into nationally-significant infrastructure projects.	WP		**Revenue negative** could be significant but depends on the design of any tax measures.	
37	Examine the following options to reduce compliance costs: *For immediate action:* a) Increasing the threshold for provisional tax from $2,500 to $5,000 of residual income tax. b) Increasing the closing stock adjustment from $10,000 to $20,000 - $30,000. c) Increasing the $10,000 automatic deduction for legal fees, and a potential expansion of the automatic deduction to other types of professional fees. d) Reducing the number of depreciation rates, and simplifying the process for using default rates. *Subject to fiscal constraints:* e) Simplifying the fringe benefit tax, and simplifying (or even remove) the entertainment adjustment. f) Removing resident withholding tax (RWT) on close company-related party interest and dividend payments, subject to integrity concerns. g) Removing the requirement for taxpayers to seek the approval of the Commissioner of Inland Revenue to issue GST Buyer Created Tax Invoices. h) Allowing special rate certificates and certificates of exemption to be granted retrospectively. i) Increasing the period of validity for a certificate of exemption or special rate certificate. j) Removing the requirement to file a change of imputation ratio notice with Inland Revenue. k) Extending the threshold of 'cash basis person' in the financial arrangement rules	MYP	s9(2)(f)(iv)	s9(2)(f)(iv)	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
	which would better allow for the current levels of personal debt. l) Increasing the threshold for not requiring a GST change of use adjustment. *The Government should also review and explore opportunities to:* m) Adjust the thresholds for unexpired expenditure, and for the write-off of low value assets. n) Help small businesses reduce compliance costs through the use of cloud-based accounting software. o) Consider compensation for withholding agents if additional withholding tax obligations are imposed. p) Review the taxation of non-resident employees. q) Review whether the rules for hybrid mismatches should apply to small businesses or simple business transactions.			s9(2)(f)(iv)	
38	Give favourable consideration to exempting the New Zealand Superannuation Fund from New Zealand tax obligations.	WP	See *Further Information on TWG issues raised* (T2019/175, IR2019/031 refers).	**Broadly neutral**	
International income taxation					
39	New Zealand should continue to participate in the OECD discussions on the future of the international tax framework.	WU		**N/A**	
40	The Government should stand ready to implement a digital services tax if a critical mass of other countries move in that direction, and it is reasonably certain New Zealand's export industries will not be materially impacted by any retaliatory measures.	WU	Cabinet approval is being sought to release a discussion document for public consultation on options for taxing the digital economy, including a digital services tax, (T2019/171, IR2019/038 refers).	**Revenue positive, d**igital services tax is expected to raise **$30-$80m**	
41	New Zealand should actively monitor developments and collaborate with other countries with respect to equalisation taxes.	WU		**N/A**	
42	Ensure, to the extent possible, that our double tax agreements and trade agreements do not restrict our taxation options in these matters.	WU		**N/A**	
Retirement savings					
43	Consider encouraging the savings of low-income earners by carrying out one or more of the following: a) Refunding the Employer Superannuation Contribution Tax (ESCT) for KiwiSaver members earning up to $48,000 per annum. This refund would be clawed back for KiwiSaver members earning more than $48,000 per annum, such that members earning over $70,000 would receive no benefit. b) Ensuring that a KiwiSaver member on parental leave would receive the maximum member tax credit regardless of their level of contributions. c) Increasing the member tax credit from $0.50 per $1 of contribution to $0.75 per $1 of contribution. The contribution cap should remain unchanged. d) Reducing the lower PIE rates for KiwiSaver funds (10.5% and 17.5%) by five percentage points each.	MYP	Officials recommend a broader range of measures (including non-income tax measures) be considered to assist low-income earners to achieve distributional objectives. Officials recommend delaying any design decisions on personal tax and welfare settings until later in 2019 to allow time to consider the Welfare Expert Advisory Group's (WEAG) recommendations and to develop an integrated personal tax and transfer package. See *Tax Working Group final report – officials' companion advice* (T2019/113, IR2019/041 refers).	Rebated ESCT exemption, **revenue negative $1.7b** Full member tax credit for KiwiSaver members on parental leave, **revenue negative $70m** Increase member tax credit to 0.75c, **revenue negative $2.6b** Decrease lower PIE rates by 5 percentage points, **revenue negative $.7b**	
44	Consider ways to simplify the determination of the PIE rates (which would apply to KiwiSaver).	WP		Revenue impact depends on design of rules concurrent measures	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
Personal income tax					
45	Recommendations on personal tax are dependent on the objectives of the Government: a) If the Government wishes to improve incomes for very low income households, the best means of doing so will be through welfare transfers. b) If the Government wishes to improve incomes for certain groups of low to middle income earners, such as full-time workers on the minimum wage, then changes to personal income taxation may be a better option.	MYP	Officials recommend delaying any design decisions on personal tax and welfare settings until later in 2019 to allow time to take into account the Welfare Expert Advisory Group's (WEAG) recommendations and to develop an integrated personal tax and transfer package. s9(2)(f)(iv) s9(2)(f)(iv)	See joint report, *Information on revenue-negative tax measures* (T2019/616 refers).	
46	Consider increases in the bottom threshold of personal tax to increase the progressivity of the personal tax system.	MYP			
47	Consider combining increases in the bottom threshold with an increase in the second marginal tax rate.	MYP			
48	Suggests that if (47) is adopted, consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase.	MYP			
49	Prefer increasing the bottom threshold to introducing a tax-free threshold.	MYP			
50	Consider an increase in net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same income.	MYP			
51	Consider changes to tax rates and thresholds alongside any recommendations made by WEAG.	MYP			
52	No reduction in the top marginal tax rate because it is already low by international standards and it would not increase progressivity of the tax system.	NFW			
53	The TWG notes that many submissions called for increasing tax personal tax rates to make a material reduction in income equality through the personal tax system. These increases are precluded by the TWG's Terms of reference and the TWG did not undertake an analysis of the options (and their effectiveness).	NFW	Outside of the scope of the TWG.		
Future of work					
54	Support Inland Revenue's efforts to increase the compliance of the self-employed, particularly expanding the use of withholding tax as far as practicable, including to platform providers such as ride-sharing companies.	WU	Budget funding has been allocated, and this is on the Government's current tax policy work programme.	**Revenue positive,** but not quantified, also depends on design of any rules.	
55	Support the facilitation of technology platforms to assist the self-employed meet their tax obligations through the use of 'smart accounts' or other technology based solutions.	WU			
56	Continue (through Inland Revenue's current work) to use data analytics and matching information to specific taxpayers to identify underreporting of income.	WU			
57	Review the current GST requirements for contractors who are akin to employees.	WP			
58	Align the definition of employee and dependent contractor for tax and employment purposes.	WP	Will require consultation with the Ministry of Business, Innovation and Employment.		
59	Provide more support for childcare costs, with this support best provided outside the tax system.	WP		**Revenue negative,** but depends on design.	
Integrity of the tax system					
60	A review of loss-trading, potentially in tandem with a review of the loss continuity rules for companies.	MYP	Consider as part of recommendation 32.	**Revenue positive,** but not quantified, also depends on design of any rules	
61	Inland Revenue should have the ability to require a shareholder in a closely-held company to provide security to Inland Revenue if: a) The company owes a debt to Inland Revenue; and b) The company is owed a debt by the shareholder; and c) There is doubt as to the ability/and or the intention of the shareholder to repay the debt.	WP		**Revenue positive,** impact unknown	
62	Further action in relation to the hidden economy, including:	WU	See *Budget 2018: Self-employed Compliance Initiatives,* IR2018/734	**Revenue positive,** impact unknown	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
	a) An increase in the reporting of labour income (subject to not unreasonably increasing compliance costs on business). b) A review of the measures recently adopted by Australia in relation to the hidden economy, with a view to applying them in New Zealand. c) The removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.				
63	That Inland Revenue continue to invest in the technical and investigatory skills of its staff.	WU	Inland Revenue continues to invest in staff skills and capabilities, and this will be monitored on an ongoing basis.	**N/A**	
64	Further measures to improve collection and encourage compliance, including: a) Making directors who have an economic ownership in the company personally liable for arrears on GST and PAYE obligations (as long as there is an appropriate warning system). b) Departure prohibition orders. c) Aligning the standard of proof for PAYE and GST offences.	WP		**Revenue positive,** impact unknown	
65	The establishment of a single centralised Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.	WP	s9(2)(f)(iv) The establishment of a single debt collection agency for government debt would require significant consultation between government agencies and many of the benefits may instead be realised from additional information sharing.	**Unknown**	
66	That Inland Revenue strengthens enforcement of rules for closely-held companies.	WP		**Revenue positive,** impact unknown	
67	Explore options to enable the flexibility of a wider gap between the company and the top personal tax rate without a reduction in the integrity of the tax system.	WP		**N/A**	
Administration of the tax system					
Tax secrecy and tax transparency					
68	The Government should: a) Fund oversampling of the wealthy in existing wealth surveys. b) Include a question on wealth in the census. c) Request Inland Revenue regularly repeat its analysis of the tax paid by high wealth individuals. d) Commission research on using a variety of sources of data on capital income, including administrative data, to estimate the wealth of individuals.	WP		**N/A**	
69	The TWG strongly encourages the Government to release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available). The Government could consider further measures to increase transparency as public attitudes change over time.	WP		**N/A**	
70	The TWG encourages Inland Revenue to publish or make available a broader range of statistics, in consultation with potential users, either directly or (preferably) through Statistics New Zealand.	WP		**N/A**	
71	The TWG encourages Inland Revenue to collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.	WP	Officials consider this is best achieved in an overall programme to provide better quality information to Inland Revenue in general. More detailed information on environmental income and expenditure should naturally flow from taxpayers supplying more detailed financial	**N/A**	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
			information, especially for larger taxpayers.		
Ombudsman					
72	Any further expansion of the resources available to the Ombudsman should include consideration of provision for additional tax expertise, and possibly support to manage any increase in the volume of complaints relating to the new Crown debt collection agency proposed by the TWG.	WP	We consider the Ombudsman should decide where they would like additional expertise.	**N/A**	
Taxpayer advocate service					
73	Establish a taxpayer advocate service to assist with the resolution of tax disputes.	NFW	Inland Revenue have reported on this matter and no further work has been requested by Ministers at this point (see IR2018/762).	**No revenue impact,** but likely to have administrative costs	
74	Consider a truncated tax disputes process for small taxpayers.	WP		**No revenue impact,** but likely to have administrative costs	
The development of tax policy					
75	The following principles should be applied in public engagement on tax policy: a) Good faith engagement by all participants. b) Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Crown/Māori relations). c) Earlier and more frequent engagement. d) The use of a greater variety of engagement methods. e) Greater transparency and accountability on the part of the Government.	WU	These principles have been included in a draft engagement framework which officials intend to release, subject to Ministerial approval (T2018/3292, IT2018/654 refers).	**N/A**	
76	The TWG notes the need for the Treasury to play a strong role in tax policy development, and the importance of Inland Revenue maintaining deep technical expertise and strategic policy capability.	WU	Following a strategic review in mid-2017, the Treasury substantially increased its tax policy capability and it intends to broadly maintain this higher resource level over the medium term.	**N/A**	
Legislative frameworks					
77a	The TWG encourages the continuing use of purpose clauses where appropriate.	NFW		**N/A**	
77b	The inclusion of an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.	WP	Extensive consultation needed with Crown Law and the Legislation Design and Advisory Committee.	**N/A**	
Charities					
78	Periodically review the charitable sector's use of what would otherwise be tax revenue to verify that intended social outcomes are being achieved.	WU	The TWG wrote to the relevant agencies in December 2018, directing them to the TWG's analysis and recommendations. Some of these issues are already being considered as part of the review of the Charities Act 2005, or will be considered once the review is complete. Policy decisions from the review are expected to be made later this year and a bill is likely to be introduced in December 2019.	Depends on results of review	
79	The TWG supports the Government's inclusion of a review of the tax treatment of the charitable sector on its Tax Policy Work Programme, as announced in May 2018.	WU	The Government added a review of charities and non-profit organisations to the Tax Policy Work Programme in 2018 focussing on: • the appropriateness of the tax exemption for significant businesses associated with charities; and • the compliance costs experienced by small charities. The review of significant businesses will take place once the review of the Charities Act 2005 is complete, as that also involves a review of certain business activity. Some simplification measures have been included in a legislative bill currently before Parliament.	Depends on results of review	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
80-81	The TWG notes the income tax exemption for charitable entities' trading operations was perceived by some submitters to provide an unfair advantage over commercial entities' trading operations. The TWG notes, however, the underlying issue is the extent to which charitable entities are accumulating surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities.	WU	A review of the Charities Act 2005 is currently underway, led by the Department of Internal Affairs on behalf of the Minister for the Community and Voluntary Sector. This will include a review of charities that accumulate funds and charities that operate businesses. A discussion document will be released in late February for consultation until late April 2019.	**N/A**	
82	Consider whether New Zealand should apply a distinction between privately-controlled foundations and other charitable organisations	WP		**Unknown**	
83	Consider whether the deregistration tax rules could be amended to more effectively keep assets in the sector, or ensure that there is no deferral benefit through the application of these rules.	WU	Some remedial work on this issue is on the Tax Policy Work Programme and is being progressed. The broader question of whether to keep assets in the sector is best considered as part of the Charities Act 2005 review.	**Unknown**	
84	Review whether it is appropriate to treat some not-for-profit organisations as if they were final consumers, or, alternatively, whether it is appropriate to limit the GST concessions to a smaller group of non-profit bodies such as registered charities.	WP		**Revenue positive**, depends on the design of the rules	
85	Consider whether the issues identified by the TWG in relation to charities have been fully addressed or whether further action is required, following the conclusion of the review of the Charities Act 2005.	WP		**N/A**	
GST and financial transactions tax					
86	No reduction in the GST rate.	NFW	In responding to the Interim Report, the Government confirmed it is comfortable that no further work is undertaken on GST coverage.	**N/A**	
87	No introduction of exemptions to GST.	NFW		**N/A**	
88	Government monitor international developments in the area of applying GST to financial services.	NFW		**N/A**	
89	No application of GST to explicit fees charged for financial services.	NFW		**N/A**	
90	No financial transactions tax at this point.	NFW	In responding to the Interim Report, the Government confirmed it is comfortable that no further work is undertaken on a financial transactions tax at this time.	**N/A**	
91	The TWG has already reported to Ministers on the issue of GST on low-value imported goods, and the Government recently introduced legislation in December 2018 advancing proposals to address the issue.	WU	The Government introduced legislation in December 2018 to address GST on low-value imported goods.	**Revenue positive,** expected to raise $66m in 2019/20, $100m in 2020/21, and $112m in 2021/22 and out years -	
Corrective taxes					
92	The TWG supports developing a framework for deciding when to apply corrective taxes.	WP	The TWG wrote to the relevant agencies in December 2018, directing them to the TWG's analysis and recommendations.	**N/A**	
93	Review the rate structure of the alcohol excise with the intention of rationalising and simplifying it.	WP		Depends on how it is simplified	
94	Prioritise other measures to help people stop smoking before considering further large increases in the tobacco excise rate beyond the increases currently scheduled.	WU		**N/A**	
95	Develop a clearer articulation of the Government's goals regarding sugar consumption and gambling activity.	WP		**N/A**	
Housing					
96	That the Productivity Commission includes vacant land taxes within its review of local government body financing.	WP	The Productivity Commission released an issues paper for this review in November 2018, which does not explicitly provide for consideration of vacant land taxes. This could be brought to the Commission's attention through the submissions process.	**Revenue positive**, but revenue will go to local government	
97	That vacant land taxes are best levied at the local rather than the national level.	NFW		**Revenue positive**, but revenue will go to local government	
98	Repeal the ten-year rule regarding selling for a gain caused by changes in land use regulation.	WP	Officials support repealing the ten-year rule if capital gains are taxed more broadly. If not, the ten-year rule should be reconsidered in light of	**Unknown**	

Rec	TWG Final Report Recommendation	Status	Officials' comment	Revenue impact (over 5 years)	Comments
			its incentive effects on housing supply.		
99	Require disclosure of the purchaser's IRD number on the Land Transfer Tax Statement when purchasing a main home.	WP		**Revenue positive**	

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Options for extending taxation on capital gains

Date:	6 March 2019	**Priority:**	High
Security level:	Sensitive - Budget	**Report number:**	IR2019/132 T2019/618

Action sought

	Action sought	Deadline
Minister of Finance	**Read** before your meeting on 7 March	7 March 2019
Minister of Revenue	**Read** before your meeting on 7 March	7 March 2019

Contact for telephone discussion (if required)

Name	Position	Telephone
Matt Benge	Chief Economist Inland Revenue	s9(2)(a) [redacted]
Mark Vink	Manager, Tax Strategy The Treasury	

6 March 2019

Minister of Finance
Minister of Revenue

Options for extending taxation on capital gains

We understand that you are meeting on Thursday 7 March to discuss options for a package of tax reform.

In order to support that discussion, we have prepared an A3 that provides a high-level summary of the main choices involved in extending the taxation of capital gains. A separate report summarises the main options for revenue-negative measures.

Both reports summarise material that you have already received in previous reporting.

We are also providing you with advice this week on:

- Depreciation deductions for buildings.
- Design details for taxing capital gains.

We would be happy to provide any further information or analysis at your request.

Recommended Action

We recommend that you:

a **read** this report before your meeting on Thursday 7 March.

s9(2)(k) [redacted]

Mark Vink
Manager
Tax Strategy, The Treasury

s9(2)(k) [redacted]

Matt Benge
Chief Economist
Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Summary Assessment of Options for Extending Taxation of Capital Gains

	Comprehensive taxation (TWG option)	Small business and other targeted relief	Partial inclusion	All Land	Residential rental or residential rental plus second homes only
Description	• Taxation of most assets at full marginal tax rates • Capital losses deductible • Roll-overs for business reorganisations • Lower rate on capital gains at retirement for small businesses and farmers • Reinvestment roll-over for small active businesses • Roll-over at death	• Taxation of most assets • Same reliefs as TWG report • Targeted measures to relieve taxation in some circumstances • Family gifting roll over for small business and farmers • Reduced inclusion rate for small businesses and farmers • Reduced PIE inclusion rate • Annual exempt amount	• Taxation of most assets • A portion of capital gains and losses of individuals would be subject to taxation • At 75%, top rate of tax would be 24.75% similar to Australian rate of 23.5% • Same reliefs as TWG report	• All land would be taxable	• Minority recommendation • Would extend capital gains taxation only to residential property • Could either include or exclude second homes
Government's objectives	**Ranking Key**	✓✓✓ **Meets objective**	✓✓ **Partially meets objective**	✓ **Less progress relative to other options**	
Revenue over 5 years	$8.3 billion ✓✓✓	Depends upon measures ✓ or ✓✓	Greater than $6.2 billion ✓✓✓	$4.3 billion ✓✓	$2.3 billion[1] ✓
Progressivity	• Substantial increase in progressivity • Taxing financial and business assets targets increased taxation to upper income earners ✓✓✓	• Relief for small business could reduce progressivity relative to comprehensive taxation • Taxing financial and business assets targets increased taxation to upper income earners ✓✓	• Substantial increase in progressivity • Taxing financial and business assets targets increased taxation to upper income earners ✓✓✓	• Smaller progressivity benefit • Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed ✓✓	• Smaller progressivity benefit • Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed • Given limited tax base and opportunity to change land use, more pass through of tax to tenants ✓

[1] Of which about $0.4 billion comes from taxing second homes. This revenue estimate is preliminary and indicative and may change following receiving further information or quality assurance.

	Comprehensive taxation (TWG option)	Small business and other targeted relief	Partial inclusion	All Land	Residential rental or residential rental plus second homes only
Horizontal equity	• Greater improvement • More closely aligns capital income taxation to taxation of other income ✓✓✓	• Specific measures reduce horizontal equity relative to comprehensive taxation of partial inclusion • For included activities, more closely aligns taxation of other income ✓✓	• Greater improvement • More closely aligns capital income taxation to taxation of other income ✓✓✓	• Modest improvement • Evens out taxation land with fully-taxed assets • Under-taxation of capital gains on business and share assets remain ✓✓	• Least of options • Evens out taxation of residential real estate with fully-taxed assets • At the same time means harsher treatment for residential real estate than most other appreciating assets. • Under-taxation of capital gains on business and share assets remain ✓✓
Efficiency and Productivity	• Capital gains taxation raises tax on capital income reducing incentive to invest and productivity • By itself, likely to reduce efficiency and productivity although net effect with business package could be productivity enhancing • Removes tax bias across activities with different percentage of capital gains • Lock-in effect ✓✓	• Depends upon measures • Significant measures can distort activity ✓	• By itself, increases tax on business activity although net effect with business package could be more balanced • Removes tax bias taxation across activities with different percentage of capital gains • Reduced lock-in effect ✓✓	• Would be a relatively efficient tax since land in fixed supply • Under-taxation of capital gains on business and share assets remain • Lock-in effect on taxed assets ✓✓	• Like land tax, relatively efficient (non-distorting) source of revenue • Evens out taxation of rental residential real estate with fully-taxed assets • Lock-in effect on taxed assets IRD ✓✓ Treasury ✓✓✓
Sustainability	• Broadening tax base and removing untaxed income improves sustainability of tax base. • Most robust if divergence between company and personal tax rates increases ✓✓✓	• Depends upon measures ✓	• Broadening tax base and removing untaxed income improves sustainability of tax base. • More robust if divergence between company and personal tax rates ✓✓✓	• Broadens revenue base • Does not respond to divergence in tax rates ✓✓	• Broadens revenue base • Does not respond to divergence in tax rates ✓

	Comprehensive taxation (TWG option)	Small business and other targeted relief	Partial inclusion	All Land	Residential rental or residential rental plus second homes only
Integrity	• Reduces scope for companies to be used to shelter income from higher rates of personal tax • Stops conversion of income into capital gains • Reinforces fairness and sustainability gains ✓✓✓	• Depends upon measures • Would improve integrity if dividend avoidance discouraged ✓	• Reduces scope for companies to be used to shelter income from higher rates of personal tax • Some incentive for conversion of income into capital gains • Reinforces fairness and sustainability gains ✓✓	• No effect on integrity outside of labour component of real property • Need for rules for land-rich companies ✓	• No effect on integrity outside of labour component of rental residential housing appreciation • Need for rules for land-rich companies ✓
Complexity	• Increases compliance costs for all taxpayers earning capital gains • Valuations of existing assets when tax comes into effect complex especially for business assets and private shares • Complex adjustment for shares of members of corporate groups ✓	• Similar to comprehensive • Targeted measures can add considerable complexity ✓	• Similar to comprehensive • Depends upon size of discount • Need to distinguish between capital gains and income for individuals (not as difficult as for companies) ✓	• Smaller increase in compliance costs • Adds need for land-rich company rules and valuation of land on sale of business • Still need business roll-overs ✓	• Much smaller increase in compliance costs • Increases compliance costs for landlords or landlords plus those with second homes. • Valuations of existing assets less complex than other business assets and private shares ✓✓✓
Coherence	• More coherent due to more comprehensive definition of income ✓✓✓	• Targeted measures can compromise coherence ✓	• More coherent due to more comprehensive definition of income ✓✓	• Leaves fundamental incoherence of exempting a portion of income ✓	• Leaves fundamental incoherence of exempting a portion of income ✓
Other concerns		• Likely to encourage calls for more and more targeted measures, which undermines the tax base.	• Could be seen as some allowance for impact of inflation on capital gains.	• Maintains preferential treatment for some forms of saving and investment, but targets saving through land, which raises fairness issues. • Appears to target farmers	• Maintains preferential treatment for some forms of saving and investment, but targets saving through residential property, which raises fairness issues. • Adds to a number of measures that increase the tax or regulatory burden on residential property investors • Likely to have the largest pass-through to tenants of all options.

MINISTRY OF SOCIAL DEVELOPMENT
TE MANATŪ WHAKAHIATO ORA

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

Joint Report: Interactions Between Tax Working Group and Welfare Expert Advisory Group

Date:	7 March 2019	**Report No:**	T2019/531 MSD REP/19/3/172 IR2019/122
		File Number:	SH-3-2-4-10

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report prior to your meeting on 12 March 2019	Tuesday 12 March 2019
Minister for Social Development (Hon Carmel Sepuloni)	**Note** the contents of this report prior to your meeting on 12 March 2019	Tuesday 12 March 2019
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report prior to your meeting on 12 March 2019	Tuesday 12 March 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone	1st Contact
Becky Prebble	Principal Advisor, Welfare and Oranga Tamariki	s9(2)(a) [redacted]	✓
Sam Tendeter	Manager, Welfare and Oranga Tamariki		

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury, for distribution to MSD and Inland Revenue.

Note any feedback on the quality of the report

Enclosure: No.

Joint Report: Interactions Between Tax Working Group and Welfare Expert Advisory Group

Executive Summary

The Ministers of Finance, Social Development, and Revenue are meeting on 12 March to discuss potential interactions between the Welfare Expert Advisory Group (WEAG) report (delivered on 25 February, under limited circulation) and the Tax Working Group (TWG) report (publicly released on 21 February).

One outcome you may wish to seek from this meeting is that Ministers get a shared understanding of the possible overlaps between the two reports, which would inform upcoming decisions on the Government response to each. There may also be overlaps with potential Budget 2019 income support initiatives within Vote Social Development.

To support that outcome, this report sets out:

- Our overall view that the two reports have relatively limited areas where they overlap and are not inconsistent where they do.

- Areas where the reports take different approaches to some shared themes. Specifically the TWG's recommendations would increase the post-tax incomes of all individuals earning over $14,000 per year whereas many of the WEAG's recommendations are more targeted. To the extent that implementing the full suite of recommendations over the short to medium term is not feasible, Ministers may need to consider which approach aligns best with their priorities.

- Key interactions that it would be useful to understand if Ministers are considering implementing some recommendations from each report at around the same time, in particular the combined impacts on:

    - distributional outcomes

    - child poverty measures

    - effective marginal tax rates and average tax rates for different groups, and

    - replacement rates between benefit incomes and low wage incomes.

- Some areas where recommendations in one report affect the "other" side of the tax and transfer system. For example, the TWG has suggested a personal tax cut with "flow through" to beneficiary incomes, which in substance would be a benefit increase. We do not consider that any of these interface issues are likely to present significant problems if the specific recommendations were adopted, but they are factors to be aware of and in some cases may require subsequent judgments about desired impacts as they are worked through.

Recommended Action

We recommend that you **note** the contents of this report prior to your meeting on 12 March 2019.

Sam Tendeter
Manager
Welfare and Oranga Tamariki
The Treasury

s9(2)(k)

Fiona Carter-Giddings
General Manager
Employment and Income Support Policy, Ministry of Social Development

s9(2)(k)

Mike Nutsford
Policy Manager
Policy and Strategy
Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Carmel Sepuloni
Minister of Social Development

Hon Stuart Nash
Minister of Revenue

Joint Report: Interactions Between Tax Working Group and Welfare Expert Advisory Group

Purpose of Report

1. The Ministers of Finance, Social Development, and Revenue are meeting on 12 March to discuss potential interactions between the WEAG report (delivered on 25 February, under limited circulation) and the TWG report (publicly released on 21 February). The public release of the WEAG report is planned for April.

2. The Government response to the TWG is planned for April 2019 and the WEAG response is planned by July 2019.

3. One outcome you may wish to seek from this meeting is that Ministers get a shared understanding of the possible overlaps between the two reports, which would inform upcoming decisions on the Government response to each. There may also be overlaps with potential Budget 2019 income support initiatives within Vote Social Development.[1]

4. This report sets out:

    - Our overall view that the two reports have relatively limited areas where they overlap and are not inconsistent when they do.

    - Areas where the reports take different approaches to some shared themes, potentially requiring Ministers to decide which approach to prioritise.

    - Key interactions that it would be useful to understand if Ministers are considering implementing some recommendations from each report at around the same time, in particular the combined impacts on:

        - distributional outcomes
        - child poverty measures
        - effective marginal tax rates and average tax rates for different groups, and
        - replacement rates between benefit incomes and low wage incomes.

    - Some areas where recommendations in one report affect the “other” side of the tax and transfer system.

Analysis

There is limited overlap between the two reports and their messaging is not inconsistent

5. The reports of the TWG and the WEAG both address aspects of the overall tax and transfer system, but with different objectives:

[1] In addition to the income support bids that have already been submitted, the Ministers for Child Poverty Reduction and Social Development have indicated that they wish to submit a late Budget bid for the indexation of main benefit rates to wages [redacted]
s9(2)(f)(iv) [redacted]

- the TWG primarily considered the structure, fairness, and balance of the tax system, and
- the WEAG considered the welfare system (including Working for Families tax credits) to ensure people have an adequate income, are treated with and can live in dignity, and are able to participate meaningfully in their communities.

6. Consistently with both groups' terms of reference, the TWG made a number of recommendations about the personal tax system and the WEAG made recommendations about the income support system. The terms of reference of the two working groups were distinct, so in general there is limited overlap between the two reports.

7. Although the two reports address separate sides of the tax and transfer system, their recommendations are not inconsistent. In particular, the TWG report recommends that if the Government wishes to improve incomes for very low-income households, the best means of doing so is through welfare transfers (as recommended in the WEAG report). Both groups also recommend being aware of the overall impact on tax and transfers from any individual changes to tax rates or abatements.

8. Annex 1 sets out the primary recommendations of each report that address either the income support system (WEAG) or the personal tax system (TWG). For the purposes of these two reports, Working for Families tax credits have been considered part of the income support system and were included in the WEAG's Terms of Reference.

9. Both reports are broad and, consistently with their terms of reference, make a number of recommendations beyond the personal tax and income support systems. Where the reports make recommendations in the same general area – for example housing – there is broad consistency of messaging. Annex 2 sets out the key areas (outside the personal tax and income support systems) where the two reports cover similar ground and notes key recommendations.

Both sets of recommendations would be fiscally significant if adopted

10. The TWG identified a preferred mechanism for delivering personal income tax changes within its terms of reference – increasing the bottom personal income threshold, currently set at $14,000. It then identified a number of illustrative options that could be part of a revenue neutral tax package: [2]

Option	Fiscal cost	Tax saving / gain per year
a. Increase the first tax threshold to $20,000.	$ 1.2 billion (2022/23) $ 6.1 billion over 5 years	Up to $420
b. Increase the first tax threshold to $22,500.	$ 1.6 billion (2022/23) $ 8.3 billion over 5 years	Up to $595
c. Increase the first tax threshold to $30,000, and the second tax rate raised to 21%.	$ 1.6 billion (2022/23) $ 8.3 billion over 5 years	Up to $1,120 for those earning up to $30,000. Those earning above $48,000 gain $490.

[2] The Final Report also gives consideration to a tax-free zone, although this is not the Group's preferred option. A $5,000 tax free zone would cost $1.6 billion per annum (2022/23), delivering a tax saving of up to $525.

11. The WEAG has costed its recommended set of changes to the income support system (covering both level and design) at $5.2 billion per year.[3]

While there is limited specific overlap, the reports have some shared themes and to some extent propose different approaches to addressing them

12. Both sets of recommendations, either by themselves or in different combinations, would likely affect incentives to work, distributional outcomes, and child poverty measures. Previous advice on potential tax packages has considered some distributional implications of different combinations of tax changes, as did the final TWG report itself.[4] We have not yet provided advice on these implications for different WEAG recommendations, although the WEAG's final report provides some information on these impacts for its recommended package of changes to income support. We have not provided any advice on the impacts of possible combinations of measures across the two reports.

13. While at a high level both sets of recommendations aim to increase post-tax incomes for some households, the specific households affected would differ. This difference primarily arises from the different scopes of the two terms of reference. Specifically:

    - The personal income tax changes recommended by the TWG would result in higher post-tax incomes for all individuals earning above $14,0005.
    - The WEAG recommendations, in contrast, would primarily affect low to middle-income households, with gains weighted towards the poorest households and households with children (the WEAG proposed a 50% abatement rate for the Family Tax Credit for households with incomes of $160,000 and over).

14. These approaches are not in principle inconsistent: it is possible to proceed with personal tax cuts at the same time as delivering more targeted assistance to some households. However, due to the significant fiscal costs associated with either set of recommendations, it is unlikely to be possible to proceed with the full suite of recommendations from each working group in the short to medium term.

15. In deciding on responses to both reports, Ministers have choices about which approach to prioritise and will need to consider the trade-offs with the fiscal impacts, income distributions, behavioural incentives, implementation timeframes and impact on agencies.

There are recommendations that, if implemented at around the same time, would have combined impacts that it would be useful to understand in advance

16. If the Government is interested in implementing some recommendations from the TWG and some from the WEAG at around the same time (and/or some income support initiatives submitted by Minister Sepuloni for Budget 2019), it would be useful to get a better understanding of the combined impacts of those options before making a final decision.

17. For example, if Ministers were considering an increase in the bottom tax threshold, an extension on taxation of capital income, and a benefit increase, the following modelling would be desirable to ensure that the impacts of the combination are fully understood:

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[3] The WEAG's report notes that the fiscal cost of their recommended income adequacy package is estimated to be $5.2 billion per year when implemented. This figure covers proposals outlined in table 2 in the 'Achieving security requires adequate income' chapter of the WEAG's final report only.

[4] See the Final Report of the Tax Working Group; Potential revenue negative packages II (position paper for session 23 of the Tax Working Group), 22 – 23 November 2018; Fiscal and distributional analysis of tax-free zone and KiwiSaver proposals [T2019/1]; and Analysis of introducing a tax free zone into the personal tax system [T2018/3657].

[5] Taxpayers will also be affected by the TWG's proposed changes to capital income taxation and KiwiSaver.

- the distributional impacts of the changes (any plausible combination is likely to result in a more progressive system than any initiative by itself, but it would be useful to understand the extent of the changes)
- impacts on child poverty measures (these can be difficult to predict in advance due to possible changes to median incomes)
- impacts on effective marginal tax rates and average tax rates for different groups, and
- replacement rates between benefit incomes and minimum wage incomes.

18. If you are interested in pursuing other options from both the WEAG and TWG we can model the various impacts that would be relevant to that particular combination of initiatives.

There are also some specific recommendations that present interface issues

19. While as noted above there are limited overlaps between the two reports' recommendations, some specific recommendations from each report would affect the "other" side of the tax and transfer system. In general we do not consider that these interfaces present serious problems, but they are factors to be aware of and in some cases would require subsequent judgements as they are worked through.

20. **Benefit flow-through**: The TWG recommends an increase in the bottom tax threshold in order to reduce the tax paid by lower income households (noting that this change would to an extent flow through to higher income households too). Since welfare benefits are set net of tax, personal income tax cuts do not generally have an automatic impact on benefit payments.[6] The TWG recommended that any tax reductions be paired with equivalent increases in benefit levels.

21. **Change Working for Families abatement to offset tax increase:** The TWG noted that effective marginal tax rates are already high for families receiving Working For Families tax credits, and increasing the second marginal tax rate (a TWG recommendation) would increase them further. Consequently, the TWG suggested that the Government consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase, if it were to be adopted. The WEAG also recommend increases to the Family Tax Credit rate to offset the negative impact of some simplification in the income support system.

22. **Impact on rents and Accommodation Supplement:** The TWG notes that their recommendation to extend taxation on capital income may lead to some small upward pressure on rents (and downward pressure on housing prices). The WEAG report notes the housing cost pressures on low income families and recommends further housing support be provided, including increasing the Accommodation Supplement maxima to reflect movement in median rental levels over time. The timing of any impact of tax changes on rents is unknown.

23. **Effective marginal tax rates:** The WEAG notes interactions with the personal tax system when it considers the overall impact of changes to rates and abatement settings on the effective marginal tax rates facing people at different income levels. The WEAG preference is to try to smooth abatement rates alongside taxes to prevent high effective marginal tax rates at low and low-middle income levels. The WEAG's proposed Earned Income Tax Credit seeks to use the tax system to lower effective marginal tax rates at low income levels for those working, and suggests making it available to people without children, which would replace the tax system's Independent Earner Tax Credit.

Annex 1:

Recommendations from TWG and WEAG reports that address the personal income tax and income support systems

TWG recommendations about personal income tax (recs 46-52 in the report)

- Consider increases in the bottom threshold of personal tax to increase the progressivity of the personal tax system.

- Consider combining increases in the bottom threshold with an increase in the second marginal tax rate.

- If this higher tax rate is adopted, the Government consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase.

- Note the group's preference for increasing the bottom threshold to introducing a tax-free threshold.

- Consider an increase in net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same income.

- Consider changes to tax rates and thresholds alongside any recommendations made by the Welfare Expert Advisory Group.

- Not reduce the top marginal tax rate on vertical equity grounds because it is already low by international standards and it would not increase progressivity of the tax system.

- Note that many submissions called for increasing top personal tax rates in order to enable policies that would make a material reduction in income inequality through the personal tax system. As such increases are precluded by the Group's Terms of Reference the Group did not undertake an analysis of the options (and their effectiveness).

WEAG recommendations about income support (recs 20 – 23, 27, 33 in the report)

- Increase main benefits payment rates by between 12% and 47%.

- Increase abatement thresholds for main benefits.

- Index income support payments (including main benefits and Working for Families tax credits) to wages rather than prices; index Accommodation Supplement to movements in housing costs.

- Increase the government co-payment rate from 70% to 75% in Accommodation Supplement.

- Consider a Living Alone Payment to contribute to the higher costs of adults living alone.

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[6] The only welfare payments that would automatically increase under current legislation are Superannuation and the Minimum Family Tax Credit.

- Increase the rates of the Family Tax Credit and abate it more gradually for most families (i.e. at 10% from an annual family income of $48,000 to $65,000 and from 15% from $65,000 to $160,000), with higher abatement for high-income families (i.e. at 50% on family incomes over $160,000).

- Replace the In-Work Tax Credit, Minimum Family Tax Credit, and Independent Earner Tax Credit with a new Earned Income Tax Credit of up to $50 per week (a work incentive tax credit that is more targeted to people on low and middle incomes, and is for people with and without children with a family-based income test).

- Make the Best Start Payment universal for all children under 3.

- Pass on child support to receiving carers.

Annex 2: Other areas of overlap between TWG and WEAG recommendations

Debt

TWG

- Establish a single Crown debt agency, to achieve economies of scale and more equitable outcomes across all Crown debtors.

WEAG

- Continue to prioritise a reduction in outstanding benefit debt through sustainable repayments, and minimise the creation of overpayments, including reviewing recoverable hardship assistance and current practice, to be more consistent with whakamana tāngata.
- Align the regulations and practice around benefit debt so that it is treated in substantially the same way as Inland Revenue treats taxpayer debt.
- Instigate a cross-government approach to managing debt to government agencies.

Productivity

TWG

- Recommended a broad extension of the taxation of capital gains, which would help improve the allocation of investment across the economy
- Proposed reforming the treatment of black-hole expenditure, which would increase the neutrality of investment by improving incentives for innovation and risk-taking.
- Recommended changing the loss-continuity rules to support the growth of innovative start-up firms.
- Recommended that the Government consider restoring depreciation deductions for multi-unit residential, industrial and commercial buildings if there is an extension of the taxation of capital gains. This would help increase the neutrality of investment by reducing the tax cost of investing in buildings and building-owning businesses.
- Recommended a number of measures to reduce compliance costs imposed by the tax system, particularly on small businesses.
- Recommended a number of measures to support people saving for their retirement using KiwiSaver, including reducing the tax rate on income earned in KiwiSaver funds for low-income savers, increasing the Government contribution to people who are adding to their funds, and refunding the employer's superannuation contribution tax to low and middle income savers KiwiSaver funds.

WEAG

- Establish an effective employment service of the Ministry of Social Development so it is better able to assist people to obtain and keep good, sustainable work.
- Revamp active labour market, labour market, employment and training policies across government to make them more coherent and effective.

- Strengthen Ministry of Social Development redundancy support policies to better support displaced workers.

- Ensure people can resume benefits readily (to allow for unpredictable changes in income and to provide people with confidence to take up employment), including removal of income stand-down periods.

Housing

TWG

- On balance, the Group expects that an extension of capital gains taxation would lead to some small upward pressure on rents and downward pressure on house prices. These impacts are likely to be small in relation to the impacts of more fundamental housing policy initiatives, such as the Government's KiwiBuild programme.

- Suggested the Government consider whether or not it wishes to remove loss ring-fencing on residential rental property if the taxation of capital gains is extended to include residential rental investment property.

- The recommendation to provide depreciation deductions for multi-unit residential buildings would encourage the supply of rental accommodation.

WEAG

- Urgently expand and accelerate government efforts to substantially increase public housing on an industrial scale and continue urgent efforts to end homelessness.

- Increase the range of home ownership and tenure options for people on low and low–middle incomes, and increase the capacity of third-sector community-based housing providers.

- Develop and enact laws and regulations to ensure healthy homes and housing security, decent standards of housing quality, universal design, and accessibility.

- Subsidise housing costs for people on low incomes (in addition to raising main benefit rates to provide an adequate income) and ensure the combination of changes to housing support and abatement rates make households better off.

- Improve access to affordable, suitable housing support for people on low and low–middle incomes, including a range of affordable home-ownership products and papakāinga housing.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: **Summary table: Options for extending taxation on capital gains**

Date:	7 March 2019	**Priority:**	High
Security level:	Sensitive - Budget	**Report number:**	IR2019/134 T2019/634

Action sought

	Action sought	Deadline
Minister of Finance	**Read** before your meeting on 7 March	7 March 2019
Minister of Revenue	**Read** before your meeting on 7 March	7 March 2019

Contact for telephone discussion (if required)

Name	Position	Telephone
Paul Kilford	Policy Manager Inland Revenue	s9(2)(a)
Mark Vink	Manager, Tax Strategy The Treasury	

7 March 2019

Minister of Finance
Minister of Revenue

Summary table: Options for extending taxation on capital gains

On 6 March, we sent you the report *Options for extending taxation on capital gains* (IR2019/132 T2019/618 refers). Attached to that report was a table that assessed various options against the standard tax policy criteria. Your office requested that the table be condensed to a single A3. The revised table is attached to this report for discussion at your meeting on Thursday 7 March.

Mark Vink
Manager, Tax Strategy
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Summary Assessment of Options for Extending Taxation of Capital Gains

	Comprehensive taxation (TWG option)	Small business and other targeted relief	Partial inclusion	All Land	Residential rental or residential rental plus second homes only
Description	• Taxation of most assets at full marginal tax rates • Various reliefs	• Same as comprehensive • Targeted measures to relieve taxation in some circumstances	• Same as comprehensive • Only portion of gains taxable, at 75%, top rate of 24.75% similar to Australian's of 23.5%	• All land would be taxable	• Capital gains taxation extended only to residential property • Could either include or exclude second homes
Ranking Key	✓✓✓ **Meets objective**	✓✓ **Partially meets objective**	✓ **Least progress**		
Revenue over 5 years	$8.3 billion ✓✓✓	Depends upon measures ✓ **or** ✓✓	Greater than $6.2 billion ✓✓✓	$4.3 billion ✓✓	$2.3 billion[1] ✓
Progressivity	• Substantial increase in progressivity ✓✓✓	• Relief for small business could reduce progressivity ✓✓	• Substantial increase in progressivity ✓✓✓	• Some progressivity benefit ✓✓	• Smaller progressivity benefit, smaller if second home excluded ✓
Horizontal equity	• Taxes income more equally ✓✓✓	• Reduce horizontal equity ✓✓	• Taxes income more equally ✓✓✓	• Modest improvement ✓✓	• Least improvement, smaller if second home excluded ✓✓
Efficiency and Productivity	• Offsetting effects, broader taxation vs. lock-in ✓✓	• Significant measures can distort activity ✓	• Offsetting effects, broader taxation vs. lock-in ✓✓	• Would be a relatively efficient tax since land in fixed supply ✓✓	• Would be a relatively efficient tax since land in fixed supply IRD ✓✓ Treasury ✓✓✓
Sustainability	✓✓✓	✓	✓✓✓	✓✓	✓
Integrity	• Reinforces fairness and sustainability gains ✓✓✓	• Depends upon measures ✓	• Reinforces fairness and sustainability gains ✓✓	• Little effect on integrity ✓	• Little effect on integrity ✓
Complexity	• Increases compliance costs for all taxpayers earning capital gains ✓	• Targeted measures can add considerable complexity ✓	• Similar to comprehensive ✓	• Smaller increase in upfront compliance costs ✓	• Much smaller increase in compliance costs ✓✓✓
Coherence	✓✓✓	✓	✓✓	✓	✓
Overall	• Broad tax reform substantially advances fairness objectives • Complex	• Reduced fairness and efficiency benefits • Very complex	• Broad tax reform substantially advances fairness objectives • Complex	• Relatively efficient tax, but significantly affects farmers and some small businesses • Relatively complex	• Relatively efficient tax • Smaller effect on fairness • Least complex

[1] Of which about $0.4 billion comes from taxing second homes. This revenue estimate is preliminary and indicative and may change following receiving further information or quality assurance.

27.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

TE TAI ŌHANGA
THE TREASURY

Tax Policy Report: Joint Report: Further advice on capital tax design issues

Date:	11 March 2019	**Report No:**	T2019/664 IR2019/142
		File Number:	SH-13-8

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	For information.	
Minister of Revenue (Hon Stuart Nash)	For information.	

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Steve Mack	Principal Advisor, Treasury	s9(2)(a) [redacted]	N/A (mob)	
Mark Vink	Manager, Treasury		N/A (mob)	
Matt Benge	Chief Economist, Inland Revenue		s9(2)(a) [redacted]	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report	

Enclosure: No/Yes (attached) <u>OR</u> Yes (iManage links)

Tax Policy Report: Joint Report: Further advice on capital tax design issues

Executive Summary

This note responds to your request on Thursday 7 March for high-level information about potential options for the extension of the taxation of capital income. The material has been pulled together in haste, it is high level and preliminary.

The tables in appendix 1 set out a brief assessment of the two main options, and suboptions, that you requested. An overview of those options is provided below. Estimates of fiscal costs are provided in appendix 2. Appendix 3 provides more detail about the following:

1. Capital gains discount for individuals
2. Kiwisaver offsets
3. Small business exemptions
4. Real property options
5. Exemption options for residential homes

Some of these options are highly complex and were not considered in-depth during the Tax Working Group (TWG) process. Implementing them within the Government's existing timeframe would create additional risks. These risks could be mitigated by taking a staggered approach to implementation, starting with residential property on the existing time table, and then adding the other components.

Of the options raised to mitigate the impact of taxing capital gains, we recommend the discounted rate rather than exempting certain parts of the base. This comes closer to delivering the benefits of the regime recommended by the TWG than the base exemption options.

Overview of Main Options

1. **An extension of capital income taxation – with some concessions**

a) <u>A capital gains discount for individuals (across all asset classes).</u>

- A lower rate is common internationally and it reduces some costs, such as lock-in. It may also be thought of as a partial offset for the taxation of inflation, and providing a concession for long-lived assets that are used to fund retirement[1].

- While a lower rate is not as beneficial as the TWG recommendation for a comprehensive tax, we consider it much preferable to other measures being considered to mitigate the impact of the tax, such as the small business exemption.

- If a lower rate is desired, we recommend the gain be multiplied by a discounted inclusion rate. This achieves the same outcome as a lower rate, but is much simpler

[1] However New Zealand generally taxes retirement savings with far fewer concessions and distortions than other countries. In other areas of the tax system we do not generally index the tax base, and as previously advised, in the case of a *realisation*-based capital gains tax, there is already an offsetting deferral benefit.

than applying a parallel marginal rate structure for capital gains only. This is the approach in Australia. We would suggest a partial inclusion rate of about 75%. Given New Zealand's relatively low top marginal tax rate we consider this in line with tax rates in other countries.

b) Offsetting impacts on kiwisaver:

- The existing KiwiSaver policy provides a significant subsidy (the $521 annual member tax credit). If Minister's wish to provide additional support for KiwiSaver, one option is to adopt all (or some) of the TWG's KiwiSaver recommendations which are :
    - increasing the member tax credit to $.75 per dollar (a maximum of $781.50 per year),
    - reducing the lower PIE tax rates by five percentage points each,
    - rebating ESCT on employer contributions for employees earning up to $48,000 per year (and phasing out the rebate until it is fully phased out for workers earning more than $70,000 per year).

  These measures would be progressive and avoid the distortion of exempting share gains. The total 5-year fiscal cost would be $5 billion Most KiwiSaver investors earning less than $200,000 per year would be better off, assuming they invest 3% of their salary each year (and their employer matches that) and the fund invests 15% in Australasian shares (the average for all KiwiSaver schemes).

- A second option is exempting KiwiSaver from the taxation of Australasian share gains. In the absence of a cap on contributions, this would be highly regressive and incentivise a shift away from direct investment in Australasian shares (and other investment vehicles) towards investment through KiwiSaver accounts[2]. As a result, the fiscal costs could be very large (up to $3 billion over five years) if there is significant reallocation of Australasian shares held outside of KiwiSaver schemes into KiwiSaver schemes. We therefore recommend that any KiwiSaver exemption be accompanied by limits on contributions to mitigate these effects.

- We do not recommend reducing KiwiSaver tax rates (including the top 28% rate) to offset the tax on Australasian share gains. This change would be regressive and have a high fiscal cost unless limits on contributions were imposed.

c) Small business exemptions

- Providing a full exemption for small business would have substantial negative effects on the fairness, integrity, efficiency and revenue benefits of any extension in the taxation of capital income. These negative effects could potentially put at risk the overall net benefits of an otherwise comprehensive extension. A capped exemption, while limiting the negative fiscal and equity effects, would require businesses to calculate and track capital gains, even if they had no tax to pay. Compliance costs would be even higher for businesses with more than one shareholder.

- Our recommended alternative option would be to augment the TWG majority proposal, which included small rollover relief for small businesses, with rollover relief on gifting. This would mean that as long as the proceeds from selling assets are retained within a small business, no tax on capital gains need be levied even if the business is passed down to successive generations.

[2] The TWG recommended that tax apply to Australasian shares when realised (for individuals) or on accrual (for shares held by funds, including KiwiSaver). It did not recommend changing the taxation of non-Australasian shares, which is usually the fair dividend rate method. There are arguments for and against taxing non-Australasian shares in the same way as Australasian shares. If there is an exemption for gains on Australasian shares held in KiwiSaver, then the case for changing the way we tax non-Austalasian shares is reduced.

2. **Targeted extension of capital income taxation – real property**

a) Real Property (Land and Buildings) Options

- Compared with the status quo, the broader the base in extending the taxation of capital gains across real property classes, the greater the gains in efficiency, integrity and equity benefits. However,
    - If second homes are not included in the base there would be negative effects on housing supply and some additional complexity relating to distinguishing between rentals and second homes
    - The taxation of gains on commercial, industrial and rural land would involve complexity in dealing with land owned by businesses.

- Compared with the TWG's recommended broad taxation of capital gains, all of these options would offer much reduced integrity and equity benefits.

b) Options for exempting residential properties

- Exempting more properties, in addition to the family home, would generally reduce the efficiency and equity of capital gains taxation, and would lead to an increase in complexity given the need to distinguish between different property types. If the additional exemption only applied to second homes (not rentals), there could also be negative housing supply effects.

- If Ministers wished to allow more exempt more properties, we would recommend ("2a") as the least complex and most efficient and horizontally equitable of the options.

Recommended Action

We recommend that you **note** the contents of this report.

Mark Vink
Manager, Tax Strategy, Treasury

Matt Benge
Chief Economist, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

An extension of capital income taxation – with some concessions

Green = positive or broadly neutral impact
Orange = some negative impacts
Red = substantially negative impacts

Capital gains discount - relative to the TWG design of a comprehensive capital gains tax

Option	Efficiency	Equity	Integrity	Complexity	Cost	Comment
Capital gains discount *Allow individuals to discount their capital gains by, say, 25%*	Reduction in positive & negative effects relative to a comprehensive tax	Reduction in equity benefits relative to a comprehensive tax	Reduction in integrity benefits relative to a comprehensive tax	Some additional complexity arises from use of discounting	Up to $2.1 b	**Officials see a discount as a preferable option to exemptions.**

KiwiSaver (KS) exemption options - relative to the TWG design of a comprehensive capital gains tax

Option	Efficiency	Equity	Integrity	Complexity	Cost	Comment
1. TWG savings measures *Increase member tax credit, reduce ESCT, reduce KS PIE rates.*	Favours saving in KS over other vehicles, but effects are small.	Increases progressivity - but only for those able to save via KS.	No impact.	Small impacts only (arising from distinctions between KS and other PIEs).	$5.0 b	None of these options is likely to have a material impact on the amount of private saving. Option 1 is the most progressive & least distortionary option. Even if not all of the TWG savings measures are adopted, most KiwiSavers will be better off, relative to the status quo. Options 2 and 3 are the most regressive and have the highest efficiency costs. Introducing a cap on contributions will substantially reduce these negative effects.
2. Australasian shares *The TWG recommended no change to the FDR regime, so this option equates to a complete exemption.*	Favours saving in KS; may reduce liquidity in NZ capital markets.	Very regressive.	No impact.	Less complex.	Up to $3.0 b	
2a. Australasian shares, with contributions cap *Cap on tax-preferred contributions to KS.*	Favours saving in KS, but effects are limited by cap.	Somewhat regressive.	No impact.	Some complexity arises from introduction of cap.	$0.8 b	
3. Lower KS PIE rates by 1, 2, 3 percentage points *Reduce all PIE rates for KiwiSaver funds. Rates would 9.5%, 15.5%, 25%.*	Favours saving in KS; may reduce liquidity in NZ capital markets.	Very regressive. Some KiwiSavers may experience inconsistent outcomes.	Somewhat higher integrity risks.	Small impacts only (arising from distinctions between KS and other PIEs).	Up to $1.5 b	
3a. Lower KS PIE rates by 1, 2, 3 percentage points, with contributions cap *Cap on tax-preferred contributions to KS.*	Favours saving in KS, but effects are limited by cap.	Somewhat regressive.	No impact.	Some complexity arises from introduction of cap.	$0.6 b	

Small business exemption options - relative to the TWG design of a comprehensive capital gains tax

Option	Efficiency	Equity	Integrity	Complexity	Cost	Comment
1. Capped lifetime exemption *Lifetime exemption of up to $500k for gains on active assets from small active businesses*	Productivity risk (investment bias).	Reduces horizontal equity & progressivity of tax.	Compromises integrity benefits of tax.	More complex business must track gains over time.	N/A*	Officials do not support these options - but Option 3 has fewest drawbacks. Better options to help small business are: • **Immediate expensing** • **Reducing costs of compliance** • **Delayed application to small business**
2. Uncapped lifetime exemption *Uncapped exemption for capital gains on active assets related to small active businesses.*	Productivity risk (<u>large</u> investment bias).	Reduces horizontal equity. Most regressive option.	Highest integrity risks.	Less complex – businesses do not need to track gains over time.	N/A*	
3. Rollover relief *In cases of reinvestment, death, and family gifting.*	Little impact, possibly positive.	Little impact.	Low risk.	Business will need to keep track of costs.	N/A*	

Fiscal costs over five years – represent the <u>decrease in revenue</u> relative to the TWG design of a comprehensive capital gains tax.

*TWG projections doe not incorporate revenue from the sale of businesses

Targeted extension of capital income taxation – real property only

Green = positive or broadly neutral impact
Orange = some negative impacts
Red = substantially negative impacts

Real property options – relative to the TWG design of a comprehensive capital gains tax

Option	Efficiency	Equity	Integrity	Complexity	Cost	Comment
1. Tax gains on all real property *Tax gains on all residential, commercial, industrial & rural land.*	IR: Net negative impact. Tsy: Net positive impact.	Regressive relative to comprehensive tax.	Does not address key integrity issues.	Key complexity is dealing with land owned by businesses.	$4.0 b	The simplest option to implement is to tax **residential rentals & second homes** only. If Ministers wish to tax gains on all real property, officials recommend **further engagement with Māori** to identify potential impacts on collectively-owned assets and entities.
2. Tax gains on all real property, except rural land *Tax gains on all residential, commercial & industrial land.*	Rural land exemption generates new distortions.	Regressive relative to comprehensive tax.	Does not address key integrity issues.	Key complexities are land owned by businesses & establishing boundary of rural land.	$4.8 b	
3. Tax gains on residential rentals & second homes only	IR: Net negative impact. Tsy: Net positive impact.	Regressive relative to comprehensive tax.	Does not address key integrity issues.	Simpler to design.	$6.0 b	
4. Tax gains on residential rentals only	May reduce supply of rental housing.	Regressive relative to comprehensive tax.	Does not address key integrity issues.	Simpler to design.	$6.4 b	

Options for exempting residential properties – relative to the TWG design of a comprehensive capital gains tax

Option	Efficiency	Equity	Integrity	Complexity	Cost	Comment
1a. One exempt property per person in addition to the family home – may be a rental property	Smaller reduction of bias in favour of residential investment.	Regressive and reduction in horizontal equity.	No obvious risks.	Small impacts.	$1.2 b	Allowing an additional exempt home is **regressive** and will **reinforce the bias** to invest in residential property. Excluding rental homes from the exemption may have negative housing market impacts.
1b. One exempt property per person in addition to the family home – but may not be a rental property	May reduce supply of rental housing.	Regressive and reduction in horizontal equity.	No obvious risks.	Need to determine if property is rental.	$0.4 b	
2a. One exempt property per person – may be family home, bach, or rental	Affects more properties and increases investment bias to residential property.	Regressive and reduction in horizontal equity. (But fairer for people who own a property they do not live in.)	No obvious risks.	Least complex.	$0.9 b	
2b. One exempt property per person – may be family home or bach, but not rental	May reduce supply of rental housing.	Regressive and reduction in horizontal equity.	No obvious risks.	Need to determine if property is rental.	$0.4 b	

Fiscal costs over five years – represent the decrease in revenue relative to the TWG design of a comprehensive capital gains tax.

APPENDIX 2

FISCAL IMPACTS

s9(2)(f)(iv)

[redacted]

Taxing capital gains – different asset coverage	Revenue decrease over five years
Tax gains on all real property	$4.0 billion
Tax gains on all real property, except rural land	$4.8 billion
Tax gains on residential rentals and second homes only	$6.0 billion
Tax gains on residential rental only	$6.4 billion

Capital gains discount	Revenue decrease over five years
Allow individuals to discount their capital gains by 25%	Up to $2.1 billion

[3] Revenue-neutral being that the fiscal costs from 2021-26 match the revenue from taxing capital gains over this period.

Savings concessions	Revenue decrease over five years
Increase member tax credit from $0.50 to $0.75 per $1 of contribution	$2.6 billion
Refund ESCT for earning less than $48,000. Abate refund by 6 cents per dollar for those earning more than $48,000	$1.7 billion
Decrease lower KiwiSaver PIE rates	$0.7 billion
Australasian shares held by KiwiSaver are exempt	Up to $3 billion
Australasian shares held by KiwiSaver funds are exempt, alongside caps to tax-preferred contributions to KiwiSaver	$0.8 billion[4]
Lower all KiwiSaver PIE rates by 1/2/3 percentage points (*New rates 9.5%, 15.5%, 25%.)*	Up to $1.5 billion
Lower KiwiSaver PIE rates by 1/2/3 percentage points, with contribution cap	$0.6 billion

Options for exempting residential properties (relative to the TWG's 'main home' exemption)	Revenue decrease over five years
One exempt property in addition to the family home – may be a rental property	$1.2 billion
One exempt property in addition – but may not be a rental property	$0.4 billion
One exempt property per person – may be family home, bach or rental	$0.9 billion
One exempt property – may be family home or bach, but not rental	$0.4 billion

[4] This assumes that there are strong limits on contributions to KiwiSaver. Costing assumes that 10% of directly held investments in Australasian shares move to KiwiSaver funds as a result of the exemption.

APPENDIX 3

DISCUSSION OF SCOPE AND MITIGATION OPTIONS FOR TAXING CAPITAL INCOME

CAPITAL GAINS DISCOUNT FOR INDIVIDUALS

Objective

1. This option allows individuals to discount their capital gains by 25% (or any other number). This is sometimes known as "partial inclusion". The discount would also apply to trusts, KiwiSaver funds and other PIEs. The discount might be thought of as addressing several issues:

   - A partial offset for the taxation of **inflation** in capital gains.
   - Recognising that **"lock-in"** is lower by having lower inclusion rates.
   - Providing a concession for long-lived assets that have capital gains that are often used to fund **retirement**. The discount would also apply to KiwiSaver funds.

2. As such, a capital gains discount is a way of recognising concerns raised on **inflation**, **lock-in, and retirement**.

3. It is similar in effect to having a lower capital gains tax rate, but allows this to flow through to taxpayers of all income levels, instead of maintaining a parallel rate structure.

Impacts on revenue

4. Because it only applies to individuals, the revenue estimates do not decline at a linear rate with the discount. That is, a 25% discount reduces revenues by **less** than 25%. Because we do not have good data on capital gains realised by companies as compared with individuals, it is not possible at this stage to accurately model this effect. Over the first five years, the revenue raised from a 25% discount would be **greater than $6.2 billion** (which is 75% of $8.3 billion).

Impacts on equity

5. Relative to full inclusion, the discount introduces some aspects we do not have in the rest of our tax system:

   - ***It is a partial offset for the tax on inflation***. Capital gains due to inflation are not real income. By only taxing some proportion of capital gains, a discount is a simple way to reduce or remove the tax on expected inflation. We note, however, that we do not systematically attempt to reduce the tax on inflation throughout the rest of the tax system (eg on interest income).
   - ***It allows for concessionary treatment of retirement savings***. Long-term capital gains are part of retirement savings. To achieve social policy goals the government offers concessions on other forms of retirement earnings, and a discount offers a simple method for applying similar concessions to the treatment of capital gain income. We note, however, that New Zealand generally taxes retirement savings with far fewer concessions and distortions than other countries.

6. This has inconsistent equity implications – as it treats capital gains differently than other capital income.

Impacts on integrity and complexity

7. A discount for individuals does increase complexity relative to full inclusion. This is because individuals still have to work out what are capital amounts and what are revenue amounts. This creates boundary issues that would have to be resolved.

8. Just as with full comprehensive taxation, there are still the complexities from valuation day and record-keeping with the discount.

Impacts on efficiency

9. A capital gains discount moderates the efficiency benefits and costs relative to full inclusion for individuals. There are three areas where the taxation of capital gains has efficiency or productivity costs which a discount will help alleviate:

- ***It lowers tax burdens on these forms of investment***: A discount will see the tax on those who invest in asset that appreciate increase by less, reducing the risk that overall investment will decline. The full effect on investment will depend on the revenue from the tax is spent.
- ***It removes or reduces the tax on expected inflation***. The taxation of inflationary gains was the key reason why overall investment was expected to be reduced by taxation of capital gains. If expected inflation is removed with a discount, then these investment/productivity costs are lower.
- ***It reduces lock-in***. A discount reduces the tax benefit associated with deferring the sale of an asset, which will reduce the costs associated with lock-in.

Other considerations

10. A capital gains discount is relatively common in other countries. Australia, Canada and Portugal provide a 50% discount. South Africa provides a 60% discount.

11. For a taxpayer on the top personal rate in each of these countries, the final rate for capital gains is:

Country	Top personal rate	With discount
Australia	47%	23.5%
Canada	41.5% - 54% (depends on province)	20.75% - 27%
Portugal	48%	24%
South Africa	45%	18%
New Zealand (assumes 25% discount)	33%	24.75%

12. The tax extension outlined by the TWG, coupled with a discount for individuals, brings the regime designed more in line with many other countries.

Capital gains discount vs a separate capital gains tax at a lower rate

13. A capital gains discount is preferable to having a separate capital gains tax for two reasons. Those are:

- it creates simplicity in calculating your ultimate tax liability because of integration with the existing income tax instead of a separate tax.
- It allows marginal rates to apply. In the absence of this, some taxpayers are likely to end up being taxed at higher rates on capital gains than they are on the rest of their income. (E.g. a pensioner on on a 17.5% rate who sells some shares will be taxed more highly on their share gains if the capital gains tax rate is above 17.5%).

AUSTRALASIAN SHARE GAINS AND KIWISAVER

14. We understand your objective is to ensure that KiwiSavers are no worse off under a comprehensive capital gains tax as recommended by the TWG. This notes sets out 3 options to achieve this.

15. Increased taxation is only an issue for Australasian shares, on which KiwiSaver funds are currently exempt from tax. Australasian shares make up 15% of all KiwiSaver fund assets.

16. It is not necessary to accept any of the three options. Another option is to retain status quo KiwiSaver incentives (the member tax credit). This already provides a significant subsidy for most members and would help to ensure that KiwSaver remains an attractive investment vehicle even if Australasian share gains were taxed.

Options

Option 1: Accept TWG recommendations.

17. The TWG recommendations were to tax gains on Australasian shares, but provide offsetting benefits to low and middle income earners. These benefits are:

- higher member tax credits ($0.50 to $0.75)
- ESCT rebate for income under $48,000 (phasing out to $70,000);
- Reducing the bottom two KiwiSaver tax rates from 17.5% to 12.5% and from 10.5% to 5.5%;
- Full member tax credits for KiwiSavers on parental leave, regardless of contributions.

18. We estimated these benefits, if all adopted, would more than offset the cost of taxing gains on Australasian shares for the great majority of KiwiSaver. Assuming historical returns and the average 15% portfolio investment in Australasian shares, KiwiSavers earning less than $200,000 per annum would be better off.

Option 2 – exempt gains on Australasian shares held by KiwiSaver funds.

19. This would retain the existing KiwiSaver tax treatment. If we assume no behavioural change, the fiscal cost is manageable ($520 million over the first five years). However, there is significant fiscal risk if we assume behavioural change to take advantage of the exemption (up to $3 billion over five years if there is reallocation of share investments). We would recommend some limitations to manage potential behavioural changes, eg. capped contributions or benefits (ie. the exemption only applies up to a certain amount of gain from Australasian shares).

20. This approach is the simplest in principle, as it maintains the status quo. However it will become more complicated as we add measures to manage the fiscal risk.

21. A potential cap on annual contributions could include a maximum percentage of income (eg. 10%) or a fixed amount (eg $10,000). We recommend a fixed amount, say $10,000. A percentage of income approach means higher income savers could make larger investments and gain more benefit from the exemption than lower-income savers. A cap of $10,000 represents the amount someone earning about $167,000 per year would contribute to KiwiSaver if they make a contribution of 3% that is matched by a further 3% employer contribution.

22. A disadvantage of the cap is it would limit future growth of KiwiSaver. However, savers will still be free to save outside of KiwiSaver.

23. To manage fiscal cost, an exemption could replace some of the TWG's recommendations, such as increasing the member tax credit (which is the most expensive), or rebating ESCT for low-income savers, which is administratively complex.

Option 3 - lower KiwiSaver PIE rates

24. This option would reduce KiwiSaver PIE rates by 1, 2, and 3 percentage points so they become 9.5%, 15.5% and 25%. This is to offset the taxation of share gains for all KiwiSavers. The greater reduction for the higher PIE rates is because the impact of taxing capital gains is greater for them.

25. We do not recommend this, as it is not targeted and it would not be accurate as different KiwiSavers will be invested in different proportions of Australasian shares (meaning some will be better off while others will be worse off compared with the status quo, depending on their proportionate investment in Australasian shares).

26. The fiscal cost of this, when assuming no behavioural change is approximately $0.6 billion. However, if people are able to make unlimited contributions to KiwiSaver then the fiscal cost is potentially greater and for example if all PIEs converted to KiwiSaver this would reduce revenue by approximately $1.5 billion over five years. To manage this we would recommend a contribution cap if this option was pursued (say $10,000 per year contribution cap).

Comments

27. We note that a full exemption for Australasian shares:

- would be regressive, as it will benefit the wealthiest the most (although this could also be mitigated, but not eliminated, with caps). We note that 84% of all financial assets are held by the top quintile, which suggests that most of the benefit of an exemption would also flow the top quintile in the absence of limitations.

- could adversely affect New Zealand's capital markets. If people switch from investing in the NZX directly to investing via KiwiSaver, then the liquidity of the NZX could significantly reduce with the smaller number of total investors. This concern was raised publicly during the TWG process. On the other hand, a full exemption may increase the total funds invested in the NZX.

- would be simple in principle, but contribution caps would complicate it, and would limit the amount people could save through KiwiSaver. Benefit caps would not limit the amount that could be saved, but these would be more complicated and KiwiSaver funds may have trouble implementing them given their current daily calculation method.

28. If we adopt option 1 or 3, there is a question as to whether we should tax non-Australian shares under FDR or on dividends and capital gains. However if we adopt option 2 (and exempt Australasian shares) there is less reason to consider changing the tax treatment of non-Australasian shares.

Recommendation

29. We recommend the Government either do nothing or adopt Option 1 (Accept TWG recommendation). If the Government wanted to adopt option 2 (exempt gains on Australasian shares), then we consider this would be viable if combined with a $10,000 per annum contribution cap.

SMALL BUSINESS AND FARMS EXEMPTION FROM CAPITAL GAINS TAX

Purpose of measure

1. A clear carve-out or exemption for small businesses (and farms) from capital gains taxation.

2. The measure would apply to active small businesses and not passive investments held in companies and trusts.

3. Exemptions would apply to capital gains arising on the sale of a business by the owner and on sales of assets by the business.

Options

1. Lifetime exemption up to $500,000 of capital gains on active assets for small businesses

4. Small businesses and their owners would be allowed to earn up to $500,000 of capital gains on active assets tax-free over the owner's lifetime.

2. Uncapped exemption on capital gains on active assets for small businesses

5. Exemption as above, but without a cap.

6. Australia has exemptions similar to the above, but they are linked with the Australian retirement system.

3. Roll-over relief for small businesses

7. The proposal builds upon the roll-overs for small businesses proposed by the TWG. Rollovers would be provided when:

   - The proceeds are reinvested in a small business;
   - On inheritance; and,
   - When gifted to family members.

8. Tax would be only payable on capital gains when the business was cashed out or sold to third parties. Small businesses and farmers would not have to pay capital gains tax as long as the family keeps the funds in the business. They would not, however, fully carve out small businesses from tracking costs for eventual taxation.

Targeting

9. It is necessary to provide rules to target the measure to the appropriate taxpayers and activities. Targeting provisions can be a source of significant complexity. Provisions would be required to:

Define small businesses

10. It is necessary to define which businesses qualify as small businesses. The Group proposed a limit of $5 million of sales for their reinvestment roll-over proposal. Further consideration on a robust and simple definition is necessary.

Define active business activities

11. A significant challenge is to define business activity as opposed to passive investments. Otherwise passive assets the capital gains on which should be subject to tax can be placed in active businesses and sheltered from tax.

Apply a cap

12. Applying a lifetime cap can limit revenue loss. Rules are required to prevent the cap from being multiplied. It is necessary to keep track of capital gains relative to the cap.

Impact on objectives

13. The issues for each of the options are similar.

Revenue

14. Providing an exemption for active small businesses would eliminate most revenues from taxing capital gains of small businesses over the short term.

15. There would be significant revenue risks if larger businesses and non-active investments could be structured to qualify for the exemption. Risks are significant for Options 1. and higher for Option 2.

Fairness

16. Horizontal equity would be reduced as taxpayers earning capital gains on a small active business would pay less tax that taxpayers earning the same level of other income.

17. The progressivity of the tax system would be reduced as exempt capital gains are likely to be concentrated at higher wealth individuals. Option 2. would be the more regressive option.

18. The roll-over option would tax funds that were withdrawn from the business, improving fairness relative to an exemption.

Efficiency

19. Efficiency would be reduced to the extent that investments are directed to lower productivity activities due to the exemption. On the other hand, lock in effects would be eliminated.

20. Roll-overs would facilitate efficient business relocations and redirections by eliminating capital gains taxation of the transactions.

21. The threshold could cause behavioural changes as businesses approach the threshold.

Sustainability

22. If in the future company and the top personal tax rates were to diverge further, there would be increased pressure on dividend avoidance. This problem arises with closely-held businesses, and is deterred by taxing capital gains. The exemption would mean that the problem would persist.

Integrity

23. The exemption would significantly compromise the integrity benefits of introducing capital gains taxation. There are also significant integrity challenges in the design of the exemption. The challenge is to target the measures to the intended businesses and activities. Risks include:

Multiplication of the small business limit

24. It is necessary to share the size limit across commonly-owned or controlled entities to ensure that large businesses cannot access the exemption.

Multiplication of the exemption cap of $500,000

25. Splitting ownership across a family, including children, can multiply access to the exemption.

Non-active activities

26. Passive investments like listed shares, land, and rental properties would need to be carved out of the exemption, both when assets are sold in a business and when the business is sold (complex). For example, real property associated with an active business like a farm, plant, shop or office used in a business would be exempt. But residential and commercial real estate that is let out would be taxable.

Dividend avoidance

27. A current problem arises from arrangements that exploit the non-taxation of capital gains to convert taxable dividends into exempt capital gains. This is a problem for closely-held companies. The exemption would maintain the problem, requiring special rules to deal with it.

28. The roll-overs would ensure taxation when the funds were withdrawn from the business reducing the potential for dividend avoidance.

Complexity

29. Option 1, the $500,000 exemption, would require businesses to calculate capital gains and keep track of their exemption amount. Thus, it would be as complicated as paying the tax and perhaps more so due to the need for anti-avoidance rules. Option 2, the uncapped exemption, would remove the need to calculate or keep track of gains

30. Complex rules would be required to coordinate capital gains made in a company with the share-holder’s capital gains relative to the $500,000 exemption cap.

31. All options would require complex rules to target the exemption to the desired activities. Failure to do so would impose significant revenue risks.

Overall assessment

32. Exemption from tax on capital gains for small businesses significantly compromises the Government’s fairness objective, adds considerable complexity and introduces significant risks to revenues.

33. A $500,000 exemption would not simplify compliance for many small businesses; and could increase it for some. An uncapped exemption would increase revenue risks and reduce progressivity.

34. Exemptions are not recommended by officials.

35. Roll-overs provide many of the benefits of an exemption for small businesses at lower compliance cost, with fewer revenue and integrity risks.

Alternatives for consideration

36. In addition to the roll-overs, there are alternative ways of reducing taxes for small businesses that may be simpler than an exemption from capital gains. These are

- A lower tax rate for capital gains from a small business or farm on retirement as proposed by the TWG.
- Partial expensing of capital investments. Partial expensing is equivalent to applying a lower tax rate to income arising from the investment. However, it avoids many of the problems associated with a low tax rate.
- A low tax rate for income earned by small businesses.

37. A low tax rate for small businesses was considered and rejected by the TWG. A low tax rate requires complex rules and raises integrity problems similar to an exemption for capital gains as taxpayers attempt to have non-business income taxed at the lower rate. It is less effective in promoting new activity than partial expensing as it lowers taxes on investments that have already been made.

OPTIONS FOR TAXING MORE CAPITAL GAINS FROM LAND

Overview

30. You have asked us to provide you with further advice around alternative options for limiting taxing more capital gains to land (including buildings and all other improvements to land). You have suggested four possible options for consideration being:

- Option 1: Only tax capital gains from residential rental properties
- Option 2: Tax capital gains from residential rental properties and second homes
- Option 3: Tax all capital gains from land
- Option 4: Tax capital gains from all land excluding rural land

31. This note briefly summarises the key impacts of each of these options. The table at the end summarises the impacts of each option more fully.

32. We would recommend further engagement with Māori on any of these options to extend taxing capital gains for land to ensure that the potential impacts for collectively-owned assets and entities are understood, and any unintended effects can be anticipated and addressed, as appropriate.

Options

Option 1: Residential rental properties

33. The first option is to only extend taxation of capital gains to residential rental properties.

34. This will broaden the base. It is expected this would raise $1.9 billion over 5 years. This option excludes properties that are used privately, for example a holiday home. It is relatively simple, reduces the difficulty of the initial Valuation Day exercise (as compared to a comprehensive extension) and provides a modest improvement in equity. However, it does little for sustainability or coherence of the tax system.

35. Relative to Option 2 (taxing all residential property) it raises the following concerns:

- If second homes are not taxable there is the risk that taxpayers anticipating capital gains would leave them untenanted in order to avoid the tax that would apply to rental homes, thus reducing housing supply.
- It adds a complex factual boundary between residential rental properties and second homes, particularly where there is mixed use of a property (e.g. where properties are rented part of the time).

Option 2: Residential rental properties and second homes

36. The second option is to tax all residential land. This includes land used as rental properties and second homes/holiday homes.

37. Around one third of capital gains are expected to be on residential rental property and second homes. It is expected that taxing these capital gains will raise more tax - $2.3 billion over 5 years.

38. This option has similar advantages and disadvantages to Option 1. However, this option resolves issues that arise from excluding second homes and, in particular, will not encourage vacant homes.

Option 3: All land

39. The third option is to extend taxation of capital gains to all land.

40. An extension of taxing capital gains to all non-owner occupied land is estimated to raise $4.3 billion over 5 years. Compared to Options 1 and 2 this will improve horizontal equity but still leaves other business assets and shares untaxed. The Valuation Day issues will be more complex than for Options 1 and 2 but less than for a comprehensive tax. However, this option is likely to be just as complex as a comprehensive capital gains tax.

Option 4: All land excluding rural land

41. The last option is to tax all land excluding rural land.

42. This would exclude gains from farming and other rural uses (such as forestry) from the tax. It is estimated this option would raise $3.5 billion over 5 years.

43. This will have similar advantages and disadvantages to Option 3. However, it will require "rural land" to be defined and may create incentives to retain land as rural land rather than developing it for residential or other purposes.

Preferred options

44. Officials would not recommend adopting Option 1 (taxing only residential rentals). This is because of the risk that second homes would become untenanted.

45. Option 2 (taxing residential rental and second homes) would be a good stepping stone to a comprehensive extension of taxing capital gains.

46. Officials would prefer Option 3 (taxing all land) over Option 4 (taxing all land excluding rural land) because it is more comprehensive

Key Factors		Option 2: Residential rental and second homes	Option 3: All land	Option 4: All land excluding rural land
Complexity		• As for Option 1 • Removes factual boundary between rental and second homes		• As for Option 3 • Adds some complexity in defining what is rural land, particularly compared with lifestyle blocks
Efficiency/ Productivity		• As for Option 1 • Removes risk that houses would be left vacant		
Integrity		• As for Option 1 • Removes risk that houses would be left vacant		
Equity		• As for Option 1		• As for Option 3, but no harsher treatment for rural land
Revenue impact	• Estimated revenue: $1.9 billion	• Estimated revenue: $2.3 billion	• Estimated revenue: $4.3 billion	• Estimated revenue: $3.5 billion

DETERMINING EXEMPT RESIDENTIAL PROPERTY

47. This note discusses options for exempting residential property from a capital gains tax, in addition or instead of a main home exemption. The options may address concerns that people with the following properties would be subject to tax:

- Bach owners;
- Mum and dad investors with one rental property; and
- People who live in a home they do not own, but own a property (which may or may not be rented out) in a different location.

Options

Option 1: Every person would get one exempt property in addition to their family home that they live in.

48. Under this option every person would be entitled to up to two exempt properties at any given point in time.

49. There are two sub-options that can be considered under this option:

- **Option 1A:** The additional exempt property could be a second home or bach or could be a rental property.
- **Option 1B:** The additional exempt property cannot be a rental property.

Option 2: Every person would get one exempt property

50. Under this option every person would be entitled to up to one exempt property at a given time that may or may not be their family home.

51. As above, there are two sub-options that can be considered under this option:

- **Option 2A:** The exempt property could be a main home, second home or bach or could be a rental property.
- **Option 2B:** The exempt property cannot be a rental property.

Additional options: Value cap or allowance

52. The Tax Working Group recommended that the Government consider a cap on the value of the properties subject to the main home exception but considered it outside the scope of their terms of reference. A value cap would be intended to address the "mansion effect", where capital is invested into homes rather than more productive uses. A value cap could increase fairness and reduce the fiscal cost. However, it introduces more complexity.

53. All 4 options discussed above are likely to reduce revenue relative to having an exemption for just main homes. All 4 options would also reinforce the bias to invest in residential property. A value cap may therefore be appropriate if any of the 4 options are preferred to an exemption for just the main home.

54. Overall, options 1A and 1B are likely to reduce revenue, equity and efficiency more than options 2A and B. A value cap may therefore be more appropriate if either option 1A or 1B is chosen. Under option 1 the value cap could apply to both the main home and the additional exempt property or just the additional exempt property.

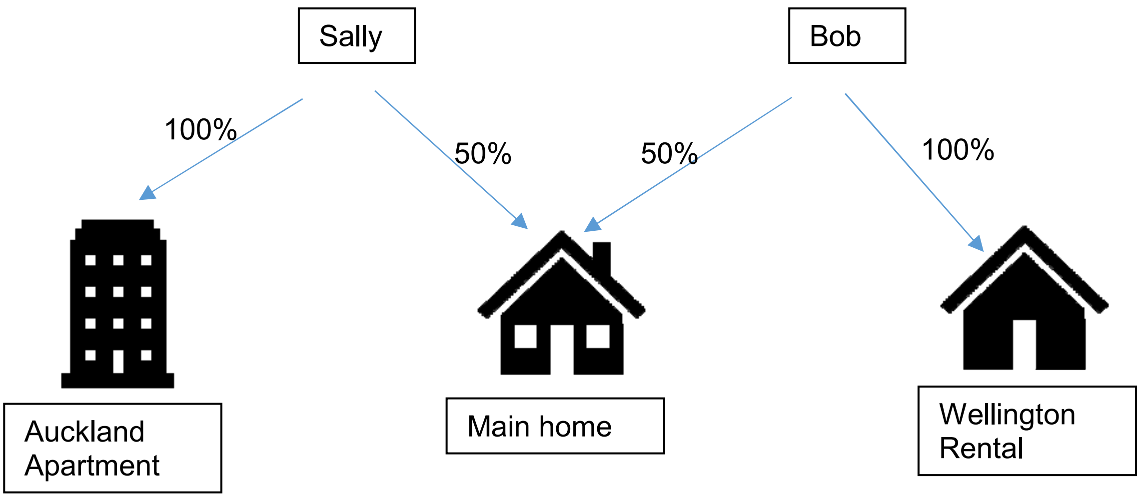
55. An alternative to a value cap that has not been explored fully is an allowance for each person (of, for example $2 million) that applies to residential property (either including or excluding rental property) that person owns. There would not be a cap on the number of properties a person could exempt, but if the sum of the value of residential properties a person owns exceeds the allowance they would be required

to pay tax on a proportion of any capital gains they make. This may provide fairness benefits (including geographical equity) but is likely to introduce significant complexity to the rules compared to the Tax Working Group's proposal or options 1 and 2.

Example

56. The following example is used to illustrate how Options 1 and 2 described above would work in practice.

57. Sally and Bob jointly own a main home together in Wellington. Sally also owns an apartment in Auckland where she stays 3 days a week while in Auckland for work. Bob also owns a rental property in Wellington.



<u>Option 1A (family home and one other property)</u> All 3 properties in the example above would be exempt.	**<u>Option 1B (family home and one other non-rental property)</u>** Sally and Bob's main home and Sally's Auckland apartment would be exempt. Bob's rental property would not be exempt.
<u>Option 2A (one property, any use)</u> Sally and Bob would each be entitled to exempt one property. Sally could either exempt her Auckland apartment or exempt her 50% share of the main home and 50% of her Auckland apartment. Bob could either exempt his rental property or exempt his share of the main home and 50% of the rental property.	**<u>Option 2B (one property, any non-rental use)</u>** Bob can exempt his 50% share of the main home. His rental property cannot be exempted. Sally can either exempt her Auckland apartment or her 50% share of the main home and 50% of her Auckland apartment.

Recommendation

58. We recommend the Tax Working Group's option of just exempting the main home.

59. We consider that there is a case for option 2A, on grounds of compliance cost reduction and fairness grounds. However, this should be weighed against the fiscal cost of option 2A.

60. We do not recommend options 1A, 1B or 2B.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

TE TAI ŌHANGA
THE TREASURY

Tax Policy Report: Joint Report: Small Business and KiwiSaver Exemptions

Date:	Friday 15 March	**Report No:**	T2019/760 IR2019/154
		File Number:	SH-13-5-2

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report.	Monday 18 March
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report.	Monday 18 March

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Mark Vink	Manager, Tax Strategy, The Treasury	s9(2)(a)	N/A (mob)	✓
Emma Grigg	Policy Director, Inland Revenue		s9(2)(a)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: No

Tax Policy Report: Joint Report: Small Business and KiwiSaver Exemptions

Purpose of Report

1. This report provides additional preliminary advice on the potential design of small business and retirement exemptions in the design of a capital gains tax, following the high-level assessment of these options provided to you on 11 March (T2019/664 refers). It also explains how the options would affect the timelines for delivering policy and legislation.

2. The advice has been developed on a tight turnaround, and there may be policy issues or delivery risks that have not been identified in the time available. Both options are complex and will need further detailed development.

3. This report focusses on how best to design these exemptions. As previously advised, officials do not recommend either the small business exemption or the KiwiSaver exemption for gains on New Zealand and Australian shares.

Small business exemption

4. Annex A outlines the key design features of a potential lifetime exemption for gains from small businesses and farms. The exemption is based on the approach taken in Australia.

5. An exemption appears feasible, but has a number of negative implications. The exemption would be complex. It would impose all of the compliance costs associated with capital gains taxation, plus additional costs to determine eligibility and operationalise the exemption itself. It would require more restrictions on deducting capital losses.

6. The exemption would introduce significant integrity risks relative to the comprehensive taxation of capital gains. The ability to sustain the tax system in the face of a divergence between company and personal tax rates would be compromised.

KiwiSaver exemption

7. Annex B outlines some of the design issues associated with a KiwiSaver exemption for gains on New Zealand and Australian shares. An exemption would generate inefficient incentives for investors to reallocate their investments to take advantage of the exemption, with associated fiscal costs. These effects would arise to some degree even if a contributions cap or other measures were in place to manage the risk.

8. Officials have explored some of the ways in which a contributions cap could be operationalised, assuming that the Government adopts the TWG's recommendation for retaining the fair dividend rate method of taxing non-New Zealand and Australian shares. However, developing a robust option for a contributions cap would require detailed work and consultation with the industry (which has not been possible).

9. Industry consultation may raise new operational difficulties that require attention. This means it could be difficult to design a KiwiSaver exemption with a contributions cap, in conjunction with the rest of the package, within the desired timelines.

10. More broadly, our work on the KiwiSaver exemption illustrates the complexities and trade-offs that will arise as the design of the tax proceeds. There is a risk that we lack a full understanding of the costs and risks of the options in the timeframe available.

11. As an example, other changes to KiwiSaver property PIEs may be required to ensure tax does not apply to the gains from property held through KiwiSaver (if the goal is that no KiwiSaver accounts are worse off from taxing capital gains). Without consultation, however, it is difficult to know the full scale of these changes.

Timelines for delivering policy and legislation

12. The Government has indicated that it will release a ‘full response’ to the Final Report of the TWG in April 2019, with legislation introduced and passed in the current parliamentary term. We are working towards Cabinet decisions on Monday 8 April.

13. As previously advised, it is feasible (with the risks we have communicated to you) to deliver a robust comprehensive capital gains tax within the current timeframes, so long as the tax is broadly consistent with the TWG majority design, and key design decisions are taken within the next few weeks.

14. A capital gains tax that involves large exemptions will differ significantly from the TWG majority recommendation. There is a higher risk of errors and unintended policy outcomes if the Government attempts to design and implement such a tax within the current timelines.

15. There are four main risks associated with delivery in these compressed timeframes:

    - **Quality assurance and costing risks.** Officials are developing options for your consideration within very short turnaround times. In this context, we are not confident in our ability to identify all of the potential policy risks associated with the options. Officials are also unable to provide robust costings within short timeframes.

    - **Insufficient time for genuine consultation.** Consultation is an important means to test the proposals, identify problems before they arise, and ensure the legislative process runs more smoothly. The timeline allows little time for in-depth consultation.

    - **Implementation and delivery risks.** There are risks to the quality of legislation if too little time is allowed for policy decisions and drafting. Allowing more time in the process will reduce the chance of errors and unintended outcomes in the bill.

    - **Impact assessments.** There is little time for officials to conduct a rounded assessment of the wellbeing impacts of the tax package, or the coherence of the final design of the tax.

16. In light of these risks, if you wish to progress a capital gains tax with exemptions, we would recommend that you consider alternative delivery timelines that could reduce the risks while still allowing announcements in April. One option is to implement a broader tax with exemptions on a sequenced timeline (implementing residential property first, followed by other included asset classes later). Another option is to make high-level announcements at April only, followed by detailed consultation; this second option would involve introducing (but not passing) legislation in the current parliamentary term.

Next steps

17. Officials would welcome further guidance on your preferred timeline for progressing decisions on the tax package.

Recommended Action

We recommend that you:

a **note** that it is feasible (with risks) to design and implement a robust comprehensive capital gains tax within current timeframes, so long as:

i. the design is consistent with the TWG majority recommendation; and
ii. key decisions are taken within the next few weeks.

b **note** that there is a higher risk of errors and unintended outcomes if the Government wishes to design and implement a capital gains tax that differs significantly from the TWG majority recommendation within the current timelines.

Mark Vink
Manager, Tax Strategy
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

Annex A: Small business and farming life-time exemption[1]

Potential approaches

1. We have examined the approaches to providing life-time exemptions in Canada and Australia. [redacted]

s6(a) and s9(2)(g)(i)

2. This note briefly describes the approaches taken in Canada and Australia[2] and then outlines the main design features and issues of a proposal for New Zealand, which are generally based on the Australian approach. The paper finishes with a simple example of how the exemption would work in practice.

Australia

3. The Australian exemptions apply to capital gains earned at the shareholder and company levels. There is a linkage between taxation of capital gains in the entity and the shareholder. Gains at the company level are notionally taxable, but can be passed out to shareholders who may apply their life-time exemption to shelter the gains from tax. This effectively links the exemption of gains in the company to the life-time exemption of the shareholder.

4. The Australian design is coherent as it applies equally to three economically equivalent transactions:

   - the sale of shares in a company holding qualifying assets;
   - the sale of those assets by a company; or,
   - the sale of similar assets, but owned through an unincorporated business (such as a sole trader).

5. One Australian exemption has a life-time cap of AU$500,000 and the other is uncapped. To qualify for the exemption the business must have less than AU$2 million (approximately NZ$2.1 million) of annual turnover and less than AU$6 million (approximately NZ$6.3 million) of net assets. Thresholds must be shared among commonly controlled businesses (40% or more common ownership).

6. The various Australian small business concessions (at least four) have different terms and conditions. While we are adopting the Australian approach, we are suggesting provisions that are adapted to the New Zealand situation.

Canada

7. In Canada, there are two types of exemption: an exemption for shares in an unlisted company and an exemption for farming and fishing assets. For small business other than farming and fishing, the exemption applies to small business shares only. Capital gains earned in the small business company itself are taxable. Therefore, economically equivalent transactions can be treated differently. The exemption is tied to the sale of a company. If an individual sells a small business which is not a company, the exemption will not apply. On the other hand, if a company sells an asset such as land or intellectual property, the capital gains will be taxed.

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[1] Throughout, references to ‘small businesses’ should be read as applying to farms as well.

[2] The Australian, Canadian and South African exemptions were described in greater detail in the report *Extending the taxation of capital gains: response to Ministers’ requests on business impacts*, (IR2019/015, T2019/18 refers).

8. There is also a wider exemption for farm and fishing property. Gains on farming and fishing assets are exempt whether held directly or in a company. Farming and fishing also qualify for the small business on sale of shares. The result is a rather ad hoc system, where farming and fishing are treated more generously than small businesses generally, and economically similar situations can be treated differently.

9. The small business exemption is capped at C$848,252 in 2018. The exemption applies to Canadian Controlled Private Corporations with at least 90% active assets. There is no size threshold. The farming exemptions are capped at C$1 million.

The proposed approach (based on the Australian approach)

10. We have developed a possible small business exemption based on Australia's basic approach. The proposal appears feasible in broad outline, but further work is required to refine these provisions to ensure that they reflect the intent of the measure and to avoid unintended consequences. The proposal is for:

- A capped lifetime exemption of $500,000 for capital gains earned by New Zealand resident individuals from qualifying small businesses;

- The exemption applies to the sale of shares of a qualifying small business and sales of assets by the small business;

    - Applies to active business assets – sales of passive assets by an "active" company would be taxable;
    - Applies to shares in companies with at least 80% or 90% active assets – so some passive assets could qualify for exemption if shares sold;
    - Need to determine what happens when a "passive" company sells an active asset;

- Closely-held unlisted companies – (LTC limit of 5 or fewer shareholders would be an option); widely-held unlisted companies would compete for funds with listed companies, the shares of which would not qualify for the exemption;

- Businesses controlled by New Zealand tax residents;

- Limited to SMEs, threshold (aggregated across group companies) less than $5,000,000 of annual sales (based on a five-year moving average); and

- No foreign assets – so that unimputed foreign income would not build up in a company not subject to capital gains tax on its shares, reduces pressure on dividend avoidance.

Design issues

11. There are a variety of design issues that will need to be settled. The objective is to provide an effective exemption for small businesses with the fewest number of unintended effects and revenue loss.

Passing capital gains to shareholders

12. Capital gains earned in the company would notionally be taxable. However qualifying companies would be not be taxed on the capital gain on active assets if they distributed the gains their shareholders. The distributions received would notionally be subject to tax in the hands of the shareholders, but would be treated as a capital gain and so would be able to be sheltered by the life-time exemption of the shareholder. This

mechanism ensures that gains are only exempt if the shareholder has exemption room left to shelter the gain.

13. Australia requires that a distribution be made to the shareholder, which seems appropriate. Distributing the funds ensures that the shareholder does not have to use their exemption twice to shelter the same gain if they sold the shares.

14. Australia allows the company to allocate the distribution among the shareholders. Consideration would be required to determine if a pro rata distribution as with imputation credits would be appropriate.

Size threshold

15. If an annual test leads to the threshold being breached, then it may be desirable to allow the capital gains earned up to that date to qualify for the exemption. This helps avoid a cliff-face where companies lose their access to the exemption by growing too much. The accrued exempt amount could be carried-forward by the shareholder until the shares are sold. In order to determine the amount of accrued capital gains, there would need to be a valuation. Valuations are complex and can be manipulated for small businesses. Rules would be required to prevent artificial losses. The effect would be that on sale of the shares, any capital gains that have accrued up to the time when the revenue threshold was breached would qualify for the exemption, while capital gains that accrued after that date would not. As with many issues, there are complex technical issues that require further consideration.

16. The size limit could be reconsidered for the exemption. The TWG proposed a limit of $5,000,000 for their roll-over concession. This would remove almost all closely-held businesses from capital gains taxation, since 98% of all New Zealand businesses have annual sales of less than $5,000,000. Australia's limit is AU$2 million. Given an exemption is a permanent elimination of tax, while roll-over only affects timing, a lower threshold might be appropriate.

Losses

17. The most serious design issue is that gains on the shares and active business assets would be eligible for exemption, but without additional measures, losses would be able to be deducted against other income. Compared to the present system, taxing small businesses would not be revenue neutral because of the life-time exemption, but would be revenue negative. The Government would get less money than under the current system.

18. A number of possible responses include:

- Capital losses on all closely-held businesses would be ring-fenced so that they could only be deducted against capital gains. This would be a sharp departure from current proposals and would effectively tax risk which could discourage entrepreneurship and disadvantage innovative businesses;

- On entering the tax system, a business would need to make an irrevocable decision about whether they wished to be eligible for the exemption on the condition that losses would be ring-fenced or opt for no exemption and no ring-fencing. The election would be required before they knew if they would have a gain or a loss;

- Losses for controlling shareholders would be ring-fenced, but losses for minority investors would not.

19. Further consideration is necessary in this area.

Integrity

20. s6(a) and s9(2)(g)(i)

21. As noted, integrity concerns under the current system involve income shifting to avoid the top personal tax rate in favour of the lower company tax rate; and dividend avoidance where the backstop function of the imputation system is avoided. Such avoidance costs revenue and is regressive as it is exploited by the better-off.

22. The exemption does not make the system worse than at present with respect to these integrity problems, since capital gains are currently untaxed. In fact, existing pressures may be reduced somewhat. Many dividend avoidance schemes seek to avoid tax on unimputed income. Unimputed income faces full personal tax rates on distribution. Currently most unimputed income is untaxed capital gains and exempt foreign income. Under the proposal, capital gains on passive assets would be taxed and capital gains on active assets would be passed out tax free. There would be no need for dividend avoidance transactions. Disqualifying companies with foreign assets from the exemption would also help by reducing the likelihood of unimputed dividends.

23. However, pressures due to the divergence of personal and company tax rates will persist; and grow if the divergence between rates were to increase in the future. The exemption would introduce a significant integrity risk relative to the comprehensive taxation of capital gains. Officials would need to examine whether specific anti-avoidance rules can be developed.

Passive assets

24. Passive assets would include listed shares, interests below some threshold in unlisted shares, and real property not connected to the active business of the company. For example, farmland and land attached to an active business premises would not be taxed, while rental real estate (residential and commercial) would be taxed.

25. If passive assets are held in a company and the company shares are sold, then some part of the capital gain on the shares could arise from gains in the value of the passive assets. A simple way of reducing this concern is to deny the exemption if the passive assets exceed some percentage of the assets of the company, say, 10 or 20% as in Canada and Australia respectively.

Multiplying thresholds

Multiplying exemptions

26. Splitting ownership across a family, including children, can multiply access to the exemption. At the least there should be a rule similar to the minor beneficiary rules to prevent dependents from holding shares to multiply the exemption.

Splitting companies

27. Larger companies can be broken up to multiply the $5,000,000 of sales threshold. It is necessary to aggregate sales across groups of commonly controlled companies when determining whether the business qualifies as small.

Rollovers

28. For consideration is whether, due to the exemption, the proposal for broad small business roll-over relief by the TWG would be replaced or modified.

An example of the exemption

29. Consider a shareholder who invests $1,000 in a company. The shareholder has a lifetime exemption cap of $500.

30. The company makes $100 from its active business operations, paying tax of $28 for after-tax income of $72, which it reinvests in active assets of the company.

31. It also sells an active asset for $200, on which it makes a capital gain of $50. The proceeds of $200 are reinvested in the active assets of the company.

32. The company makes a capital gains distribution of $50 to the shareholder, who reinvests the distribution in the company. The shareholder's cost base for their shares is increased by $50 to $1050. The company does not have to pay tax on its capital gain since it made the distribution. The shareholder would add $50 to their taxable income, but would be able to claim $50 of exemption, so there would be no net tax to pay. The shareholder would reduce their capital gains life-time exemption cap to $450 = (500 – 50).

33. The company now has assets with a market value of $1122 (=1000+72+50). The shareholder sells their shares for that amount. Their cost base is $1050, so there is a capital gain of $72. Because of the exemption, they again would have no tax to pay. The shareholder's remaining capital gains exemption cap would be reduced by a further $72 to $378 (=450 – 72).

34. The company and shareholder must fully comply with the rules of capital gains taxation, (valuation day, tracking of costs and proceeds), plus the mechanical rules to operationalise the exemption.

Annex B: Exempting New Zealand and Australian shares gains for KiwiSaver

1. As discussed at the Joint Ministers meeting on 12 March, if KiwiSaver accounts are exempt from paying tax on New Zealand and Australian share gains, officials recommend that there be a cap on this benefit. This is to prevent tax planning whereby Australasian shares are predominantly held through KiwiSaver (instead of other vehicles, including held personally). The change to a cap will cause some complexity both in the KiwiSaver rules and in administration of KiwiSaver funds.

2. As an initial point, we note that non-New Zealand and Australian shares would not need an exemption because they are already taxed comprehensively under the *Fair Dividend Rate* (FDR) regime.

3. This regime deems 5% of the market value to be income, on which tax is paid. Some in the media have raised the question of whether FDR is concessionary relative to capital gains tax treatment. However, once accounting for risk, including the fact that FDR is paid even when a fund earns less than 5%, and even when the return is negative, economically FDR is not concessionary relative to capital gains tax treatment. We will report further on this issue and how we propose to deal with it in the week beginning 18 March.

4. There may also have to be an exemption for capital gains through property PIEs where the property PIE itself is not a New Zealand or Australian listed company. These are small in number and value in regard to KiwiSaver, but would require consultation with the specific providers on to how to make such a system work.

5. The rest of this note covers initial analysis of how a KiwiSaver exemption for New Zealand and Australasian shares and the cap could work. Further work on this is required.

KiwiSaver exemption

6. The exemption for Australasian share gains for KiwiSaver PIEs but not other PIEs would require some systems changes for PIEs.

7. There is currently no tax distinction between a KiwiSaver PIE and a non-KiwiSaver PIE. This would have to change.

8. Investors invest in retail PIEs. These PIEs in turn invest in wholesale PIEs. The retail PIEs calculate tax obligations for the investors after receiving information on returns from wholesale PIEs.

9. Wholesale PIEs would have to collect and pass on information to retail PIEs on what amount of their return was attributable to New Zealand and Australian share gains. KiwiSaver PIEs would not pay tax on this income (unless the cap applied to the share gains rather than contributions – see below), but other PIEs would.

10. We would want to consult with the industry about other fishhooks, and the level of systems change this would require, but at this stage we do not think that these changes would be unduly onerous depending on measures to manage fiscal risk.

Behavioural response and fiscal risk

11. Exempting New Zealand and Australian share gains will incentivise behavioural responses and have a fiscal risk, as well as be a regressive exemption relative to taxing gains comprehensively. If there is no increase in investment in New Zealand and Australian shares through KiwiSaver compared to the historical average, the fiscal

consequences are manageable. However, there will be a strong incentive for investors who invest is such shares to do so through KiwiSaver.

12. This would be inefficient, distorting such investments to be held in institutional funds, and also create a fiscal risk as more New Zealand and Australian share investments are moved from being held outside KiwiSaver to be held through KiwiSaver.

13. With no restriction on how much New Zealand and Australian shares can be held in KiwiSaver, potential fiscal costs are:[3]

Cost of exempting KiwiSaver ($billion)	Five year total
No behaviour change	0.5
10% of shares held directly or by non-KS managed funds are converted to KS	0.8
20% of shares held directly or by non-KS managed funds are converted to KS	1.2
30% of shares held directly or by non-KS managed funds are converted to KS	1.5
50% of shares held directly or by non-KS managed funds are converted to KS	2.2

14. Two general approaches to manage fiscal risk are caps on contributions or benefits.

(a) Contributions cap

15. Currently, employees can elect to have their employer withhold and contribute 3%, or 4%, or 8%. From 1 April 2019 KiwiSaver employee contributions can also be 6% and 10%. Employers contribute 3%.

16. The simplest option would be to cap contributions at 6% (so remove the 8% and 10% options), and prevent employees from making voluntary contributions beyond this. This would, in effect, cap contributions at 6% of salary plus the 3% employer's contribution. In total, this would be 9% of an employee's salary.

17. Because the cap is linked to income, higher income taxpayers receive a higher dollar benefit of the tax concession, which some may regard as unfair.

18. Officials' initial view on a dollar amount cap is that such a system would be much more administratively complex in situations where people have two employers, and might result in situations where KiwiSaver providers had to refund the contributions to employers, who would then refund it to employees.

19. For self-employed or non-employees, there would have to be a dollar cap, or perhaps a percentage of the prior year's income. If it were a dollar cap, the amount would inevitably be arbitrary, but could, for example, be $18 000, which is 9% of $200 000. KiwiSaver funds would have to enforce this cap for the self-employed, which would require systems changes that we would want to consult on before providing final advice.

20. Because KiwiSaver accounts have no restrictions on withdrawals for those aged over-65, to reduce fiscal cost there may be a need to prevent those aged over-65 from contributing any additional money to KiwiSaver, given the locked-in nature of KiwiSaver is not providing any protection from planning opportunities from those over-65.

21. A weakness of the cap is the inability to restrict reallocation into KiwiSaver before the cap comes into effect. Because the cap must be enforced by the funds, it is impossible to implement the cap without giving prior notice. During this period, investors may freely make large investments into KiwiSaver funds that invest in New Zealand and Australian shares (funded by selling investments outside of KiwiSaver).

[3] These estimates are early and indicative and provided for illustrative purposes only

22. Even after the cap is introduced, there is likely to be substantial reallocation through investors switching their KiwiSaver accounts to have a greater focus on New Zealand and Australia, with corresponding offsetting changes in what other assets they hold outside KiwiSaver over time.

(b) Cap on untaxed New Zealand and Australia share gains

23. Another option is to have a rule that allows each KiwiSaver investor to have (say) $5000 of gains in New Zealand and Australian shares untaxed each year, with tax applying to amounts greater than this.

24. The advantage of this is it limits the benefit, similar to other KiwiSaver incentives (the Member Tax Credit). It is also progressive, with the benefit capping out for wealthier investors. It manages fiscal risk better than the contributions cap, because levels of contributions to KiwiSaver would not matter (there would be no need to cap these, and no risk of pre-implementation manipulation and tax planning).

25. There are two issues with this rule. It will likely be administratively more difficult to implement (and we would want to consult on this to find out just how much more difficult). Also, if the cap is to be binding, it will end up taxing some KiwiSaver accounts more than the status quo, which may not meet your objectives (although this can be calibrated so *most* KiwiSaver investors will not be worse off).

(c) Increase member tax credit

26. If your goal is that *most* KiwiSavers will be no worse off, and many will be better off, another alternative to the “exemption plus cap” is to increase the Member Tax Credit.

27. This is less distorting, but is generally more costly than either (a) or (b). Because some accounts will have large New Zealand and Australian share gains in their KiwiSaver accounts (because their account balance is high, or because their allocation to New Zealand and Australia is high, or both), it is impossible to ensure that no KiwiSaver account is worse off through the Member Tax Credit (although it could be calibrated so most individual members are better off).

28. Even an increase in the Member Tax Credit to $781.50 (the Tax Working Group proposal) will only be enough to offset the taxation of $929 in New Zealand and Australian share gains at 28%. If someone has a $50 000 KiwiSaver balance allocated to New Zealand and Australian shares, this would mean that a mere 2% increase in the balance derived from capital gains would make them worse off than if the gains had not been taxed.

29. If you are interested in proposals that ensure that *most* KiwiSaver accounts are better off, while accepting that some will be worse off, officials could work on variants that try to make *most* KiwiSaver contributors better off at lowest fiscal cost.

Annex C: Data on small business

1. Table 1 provides the number of businesses and assets held by businesses with turnover of less than $5 million.

Table 1: Number and assets of small businesses

	Businesses with less than $5m turnover	Percentage of total businesses
Number of businesses	452,730	98%
Value of 'fixed assets' held (land, buildings, machinery)	$255 billion	59%
Value of 'total assets' held (fixed assets plus intangibles, subsidiaries, bank deposits and any other assets held)	$815 billion	43%

Source: Statistics New Zealand, Annual Enterprise Survey
Note: Results exclude residential property investors. 'Total assets' include intangible assets such as goodwill that many small businesses may not value. As a result, the value of 'total assets' for small businesses may be understated.
'Total assets' include a significant amount of financial assets held by the finance industry. If the finance industry is removed from these results then the total assets held by small businesses decreases to $420 billion which make up approximately 50% of total assets held by businesses (excluding the finance industry).
The Annual Enterprise Survey generally only includes businesses with at least $30,000 of taxable supplies. As a result, this data will exclude some very small businesses.

2. Tables 2 and 3 (over the page) provide the total number and value of assets held by small businesses split by industry (for industries with at least 10,000 businesses).

Table 2: Number of small businesses by industry

	Businesses with less than $5m turnover	Percentage of total businesses in the industry
Agriculture, forestry, and fishing	69,432	99.2%
Manufacturing	19,809	92.7%
Construction	55,095	97.7%
Wholesale trade	15,843	89.4%
Retail trade	26,307	94.6%
Accommodation and food services	20,361	98.9%
Transport, postal, and warehousing	15,354	96.8%
Financial and insurance services	18,717	96.0%
Rental, hiring, and real estate services	76,533	99.3%
Professional, scientific, and technical services	55,602	98.5%
Administrative and support services	16,554	98.2%
Health care and social assistance	18,159	98.1%

Table 3: Total assets of small businesses by industry

	Value of 'total assets' by businesses with less than $5m turnover in industry	Percentage of total assets held by businesses in that industry
Agriculture, forestry, and fishing	$131 billion	84%
Manufacturing	$9 billion	12%
Construction	$16 billion	52%
Wholesale trade	$9 billion	20%
Retail trade	$9 billion	35%
Accommodation and food services	$9 billion	66%
Transport, postal, and warehousing	$10 billion	25%
Financial and insurance services	$398 billion	37%
Rental, hiring, and real estate services	$171 billion	80%
Professional, scientific, and technical services	$19 billion	35%
Administrative and support services	$5 billion	52%
Health care and social assistance	$8 billion	42%

Total fiscal impact of exempting small businesses

3. We have not forecast the total fiscal cost of exempting small businesses because we are unable to forecast revenue from the sales of businesses due to a lack of available data.

4. Despite this difficulty in quantification, we expect the fiscal cost of exempting the sales of small businesses from a tax on capital gains to be potentially significant. The Reserve Bank estimates that the value of unincorporated businesses and unlisted shares held by New Zealand households is approximately $430 billion (which is approximately 20% of all household assets in New Zealand for December 2018).[4]

5. In addition, in Australia, the total amount of gains available for small business concessions was $4.4 billion in 2015/16. This implies that at least 12% of capital gains in Australia were a result of the sale of small businesses or assets held by small businesses that were eligible for the exemption.

6. A small business exemption would also reduce the revenue from taxing gains from the sale of non-residential property. However, this is not expected to result in a large reduction in revenue compared with that previously reported to you, This is because the fiscal cost of exemption in the short term is expected to be similar to the cost of the small business rollovers recommended by the TWG.

[4] The housing and land value in the calculation is taken for September 2018, due to data not being available for December 2018.

Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

Briefing note

Reference: BN2019/165

Date: 19 March 2019

To: Tax Advisor, Minister of Finance – Kieran Kennedy
Revenue Advisor, Minister of Revenue – Paul Quirke
Private Secretary, Minister of Revenue – Larissa Anderson

cc: Naomi Ferguson, Commissioner
Cath Atkins, Deputy Commissioner
Matt Benge, Chief Economist
Emma Grigg, Policy Director
David Carrigan, Policy Director
s9(2)(a) [redacted]
Government & Executive Services (Ministerial Services)
Policy records management (PAS RM)

From: Paul Kilford / Mark Vink

Subject: **Timeline for decisions: Tax Working Group**

Officials would like to discuss with Ministers the timetables for the Governments "full response" to the Final Report of the Tax Working Group. The attached table sets out alternative timetables to the current one based on Cabinet decisions on Monday 8 April.

We have assumed that Cabinet decisions could be deferred until after the Budget moratorium period, which ends after Budget on May 30. The decisions Ministers would be seeking from Cabinet would include the Government's response to the TWG recommendations on:

- Extending the taxation of capital gains;
- Packages to improve the structure, fairness and balance of the tax system;
- Other recommendations made by the TWG.

It would also agree a process for communication and consultation on the Government's response.

The table covers the key dates that would form part of any consultation/legislative process and the types of tax package that we consider to be feasible to deliver within certain timelines. We would be happy to provide Ministers with more detail around our suggested timelines including Ministerial engagement.

Note that when the table refers to something as being "unachievable", this means that we consider there is a high risk with delivery in compressed timelines. As noted in our report last week these include quality assurance and costing risks, insufficient time for genuine consultation, implementation and delivery risks and overall impact assessments.

The table highlights our view that, if decisions are to be postponed, the only capital gains extension that could realistically be enacted this Parliamentary term is the TWG minority "residential land only" design. Other packages could be introduced, but our judgement is that attempting to enact them would be extremely high-risk.

An assumption underpinning the timelines (as they relate to capital gains) is that "announcements" will mean that the Government has made firm decisions on the fundamental building blocks, so consultation can be on detailed design elements necessary to bring those decisions into effect.

We see those building block decisions as covering:

- The realisation nature of the tax;
- Applicable tax rates;
- The assets covered;
- The nature of any rollover reliefs being considered;
- How losses will be treated;
- The effective date and transition method.

Having a good steer from Ministers on the form of the expected Cabinet paper as soon as possible will give us time to assist Ministers though the remainder of the decision-making process and also produce a good quality consultation document for a July release. In particular, with a June Cabinet decision, there is scope for Ministers to decide relatively early what assets classes they would like to include in the tax net. This will allow us to provide further advice through the Budget moratorium on the ancillary rules that may be needed to support such a tax.

Budget implications

The budget moratorium places some constraints on the timelines for decision-making. We have been targeting the date of Monday 8 April for Cabinet decisions on the tax package. This is the latest possible date that can be accommodated within the timelines for finalising budget forecasts.

Budget 2019 will be delivered on Thursday 30 May. This means the space for Cabinet decisions will open again from the start of June (note this means that no Cabinet Committee or Cabinet decisions can be taken prior to 30 May).

In the meantime, while decisions are still impending, it will be necessary to retain the existing specific fiscal risk for potential tax policy changes in the Budget Economic and Fiscal Update.

Paul Kilford
Policy Manager
s9(2)(a)

Mark Vink
Manager, Tax Strategy
s9(2)(a)

Timeline options: taxing more capital gains

Decisions	Announcement	Consultation starts	Legislation introduced	Enactment / effective date	Content of package	Officials' comments, including Budget implications
April (Cabinet)	April	Late May	Late 2019	2020 / 1 April 2021	Either: • Minority only • Majority only	Any significant deviations from the TWG majority package, including KiwiSaver and/or small business exemptions makes enacting a variation of the TWG report on this timeline unachievable.
April (Cabinet)	June	June	Late 2019	2020 / 1 April 2021	Minority only (including second homes) – either as the final package or as phase one of a two-stage process	
Between April and June (Ministers and Cabinet)	June	Between July and September depending on timing of Ministerial decisions	Mid 2020	2021 / 1 April 2022	Any package, including phase two of a staggered approach (effectively a combination of this row and the row above)	The later decisions are taken, the shorter the consultation period, with associated increase in risks.

Inland Revenue
Te Tari Taake

TE TAI ŌHANGA
THE TREASURY

Briefing note

Reference: BN2019/210
T2019/1071

Date: 10 April 2019

To: Tax Advisor, Minister of Finance – Keiran Kennedy
Revenue Advisor, Minister of Revenue – Paul Quirke
Private Secretary, Minister of Revenue – Larissa Anderson

cc: Naomi Ferguson, Commissioner
Cath Atkins, Deputy Commissioner
Matt Benge, Chief Economist
Emma Grigg, Policy Director
David Carrigan, Policy Director
s9(2)(a)
Government & Executive Services (Ministerial Services)
Policy records management (PAS RM)

From: Paul Kilford, Policy Manager, Inland Revenue
Mark Vink, Manager, The Treasury

Subject: **Taxing residential property - Main home plus one exclusion rule**

Purpose

This briefing note provides you with details of the costings and policy considerations for a proposal to have a main home plus one exclusion rule for the extension of the taxation of capital gains to residential property.

This note has been prepared in haste, officials have not had the opportunity to consider this proposal in any depth. This note outlines a number of key policy issues we have identified. Some of these are complex. We are not confident that we can advise Ministers on all of the considerations and potential implications of this proposal in time for an April announcement.

Summary of general design details

We understand that the proposal is to allow each person to have one main home, and one other property that is excluded from the extension of the taxation of residential property. This section outlines some of the key features that would need to be considered in such a design:

- The restriction to one main home will mean that, where two or more people share one main home, that one property will be the main home of all of those people.

- It will be necessary to consider whether all individuals will be able to have a main home, plus one other property, or whether this should be limited to individuals over the age of 18. This will affect the costings for this proposal because those with multiple rental properties may hold them in their children's name to get additional exemptions. The more people who are able to have an excluded home, the less tax is likely to be collected from any extension of the taxation of residential property.

- It will be necessary to consider whether entities other than individuals can own an excluded property. Many properties in New Zealand are owned through a trust or company structure. A trust can hold multiple properties for multiple beneficiaries. A company can also be owned by a number of people. Rules around the types of structures that can be used to hold excluded properties could become quite complex. Depending on the design, this could also have a significant impact on the tax that is likely to be collected from any extension of the taxation of residential property.

- There will need to be rules around the disposal and acquisition of excluded properties to determine, where a person has more than two properties that could be excluded, which properties are the excluded properties. These rules could become quite complex, and lead to complex structuring. Depending on the nature of these design decisions this may have significant impact on the tax that is likely to be collected from any extension of the taxation of residential property (see Appendix One for an example of how this may work in practice).

- If it is decided to have an exclusion for a second property, we would recommend that the bright-line test is retained, so that if the second property is sold within 5 years, it would be taxed.

We consider that there is a significant risk of people structuring so that they only ever own excluded properties (either by transferring properties to associates, or by exiting the market altogether). Where people do not only own excluded properties, we consider that there is a risk that people will seek to have valuations that are favourable to them.

Both administrative and compliance costs would be higher under this proposal than under the status quo, and under a proposal for only the main home to be excluded.

If the intention of allowing two excluded properties per individual is to ensure that existing investment properties are not taxed, officials consider that taxing all residential property (excluding the main home), but on a grand-parented basis, would be a better option. This would mean that only properties purchased after the introduction of the new tax would be taxed. However, this option is likely to result in no additional revenue for the first five years.

Fairness and efficiency

The rules outlined above will significantly affect the fairness and efficiency of the tax extension.

By exempting more properties, the horizontal equity benefits of the tax are reduced. Because the exemption is related to numbers of properties rather than value or income, the fairness implications will tend to be arbitrary. As an example, a property worth $400,000 will qualify for the exemption, as will a $2m property. These two properties will likely end up producing very different amounts of exempt capital gains income.

In officials' view, the efficiency impacts will make the rule described above worse than the status quo. The rule will have higher administration and compliance costs than the status quo or a broader extension that exempted only the main home. The rule will encourage small scale ownership over professional landlords. These compliance, administration, and distortionary ownership costs are likely to be high when compared to the revenue raised. In addition, the exemption that favours small scale is likely to increase rents more than just having a main home exemption, because of the reduced competition from larger-scale landlords.

Costings

Revenue estimate for taxing residential property

Table 1 below provides the estimated revenue from taxing capital gains from residential property where individuals get the family home excluded as well as one additional residential property.

Estimated revenue $b	*2021/22*	*2022/23*	*2023/24*	*2024/25*	*2025/26*	*Total over five years*
Revenue from taxing capital gains from residential property where individuals have family home exempted and an additional residential property	0.01	0.05	0.13	0.21	0.30	0.7

There is a high degree of uncertainty with this revenue estimate. The estimate relies on behavioural assumptions, and assumptions regarding the design of the exemption. In addition there are data limitations that mean it is uncertain how many residential properties each New Zealander owns. These are considered further below.

Design decisions assumed in revenue estimate

The assumed design of the exemption heavily affect this revenue estimate. This revenue estimate is on the basis that the exemption follows the following design:

- ***Election of exemption:*** People elect which property is exempt prospectively (i.e. on purchase, valuation day, or when previously exempt property is sold)
- ***Valuation day for new exemptions:*** When an exempt property is sold, any new property that is elected for an exemption only has gains made after the election date exempted from the capital gains tax
- ***Bright-line test:*** The five-year bright-line test continues to apply. This means that the additional property exemption does not apply to property sold within five years of acquisition
- ***Companies, trusts and minors:*** There are strict rules to prevent people obtaining the exemption multiple times through companies, trusts and their children.

The revenue could be significantly less, and potentially nil (or negative if the bright-line is repealed) if there is a different design.

Assumptions used for costing

The costing incorporates a behavioural assumption that every existing landlord effectively gets two rental properties exempted in addition to their main home. This additional exemption is because we assume that most landlords will transfer rental properties to associates (such as their partner) who do not currently own a rental property to obtain the exemption. This results in 63% of rental properties being exempted[1].

We have assumed that all second homes are exempted under this proposal. This is on the basis that it would be relatively simple for most owners of second homes to transfer property to an associate to obtain the benefit of the exemption and it is unlikely that people will own multiple additional homes.

[1] Based on analysis of MBIE data on the number of properties held by each landlord.

There are other potential behavioural changes that could also affect the revenue that are not incorporated in this costing. For example, the costing does not incorporate how taxpayers may choose the property most likely to earn capital gains as their exempt property and does not incorporate the ownership of rental property likely being increasingly owned by smaller landlords.

Paul Kilford
Policy Manager
Inland Revenue
s9(2)(a)

Mark Vink
Manager
The Treasury
s9(2)(a)

Appendix One – Example

Tom and Samantha own five rental properties, a bach, and a family home on valuation day.

On valuation day, they nominate two of their five rental properties to be exempt properties. They do not nominate the bach to be exempt because they do not intend to sell it, so the exemption is of little value.

They can nominate two rental properties instead of one, because there are two of them and the income tax system operates on an individual basis.

After 6 years Tom and Samantha sell one of their exempt properties. This property is legally owned by Tom, and no tax on the gain is paid. At that point, Tom is not using one of his exempt property entitlements, and so he nominates one of their remaining three non-exempt properties to now become exempt.

Because that property was not exempt for the first six years after valuation day, a new valuation is required to ensure that when this now-exempt property is sold, tax is paid on the gain for those six years[2]. The property had increased in value from $500 000 to $600 000 during those six years. As a consequence, when that property is eventually sold, tax of $33 000 (assuming a 33% tax rate) will be paid.

After a further four years, Samantha sells her exempt property, and the couple buy another property. Samantha elects for this property to be her additional exempt property.

[2] Without this rule no tax would ever be paid under this regime.

Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

TE TAI ŌHANGA
THE TREASURY

Tax Policy Report: Joint Report: Cabinet Paper: Government Response to the Tax Working Group - final version for lodgement

Date:	12 April 2019	**Report No:**	T2019/1076 IR2019/213
		File Number:	SH-13-8

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the content of this report **Authorise** the lodgement of the attached Cabinet paper	3pm 12 April 2019
Minister of Revenue (Hon Stuart Nash)	**Note** the content of this report **Authorise** the lodgement of the attached Cabinet paper	3pm 12 April 2019

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
s9(2)(a) [redacted]	Analyst, The Treasury	s9(2)(a) [redacted]	n/a (mob)	✓
Mark Vink	Manager, The Treasury		N/A (mob)	
Emma Grigg	Policy Director, Inland Revenue		N/A (mob)	

Actions for the Minister's Office Staff (if required)

Return the signed report to Treasury.

Lodge the Cabinet paper with the Cabinet Office by 3pm 12 April 2019.

Note any feedback on the quality of the report	

Enclosure: Yes (attached)

Tax Policy Report: Joint Report: Cabinet Paper: Government Response to the Tax Working Group - final version for lodgement

Attached for your signature and referral is a paper for consideration by Cabinet at its meeting on Monday 15 April.

The purpose of the paper is to seek Cabinet's agreement on the Government's response to the Tax Working Group's (TWG) Final Report. The paper recommends that Cabinet agree not to implement any extension of capital gains taxation.

The paper also recommends that Cabinet agree to the proposed response to the TWG's other recommendations, as indicated in the table appended to the paper. The proposed response includes consideration of some of the TWG's recommendations for inclusion in the 2019/20 Tax Policy Work Programme (TPWP) and/or other agency work programmes. A subset of the TWG recommendations are proposed to be considered as a high priority for inclusion in the 2019/20 TPWP and/or other agency work programmes.

The TPWP is jointly agreed by the Minister of Finance and the Minister of Revenue. Officials will provide you with further advice on the TWG recommendations alongside other potential measures for potential progression in the 2019/20 TPWP and/or other agency work programmes.

After the TPWP has been agreed by joint Ministers, it is taken to Cabinet for noting. This will provide Cabinet an opportunity to note which of the TWG's recommendations have been included in the TPWP.

A regulatory impact statement is not required for this Cabinet paper as it does not contain regulatory proposals.

The Cabinet paper needs to be submitted to the Cabinet Office by 3pm on Friday 12 April for discussion at Cabinet on Monday 15 April.

Recommended Action

We recommend that you:

a **note** the contents of this report

Noted | Noted

b **authorise** lodgement of the attached Cabinet paper *Government Response to the Tax Working Group* by 3pm 12 April 2019

Authorised/Not authorised | Authorised/Not authorised

Mark Vink
Manager, Tax Strategy
The Treasury

Emma Grigg
Policy Director
Inland Revenue

Hon Grant Robertson
Minister of Finance

Hon Stuart Nash
Minister of Revenue

From: ^IRD: Paul Kilford
Sent: Friday, 12 April 2019 5:09 PM
To: ^Parliament: Keiran Kennedy
Cc: ^IRD: Emma Grigg
Subject: Fwd: Speaking notes

Hi Keiran

See below.

Have a good weekend.

Paul

From: Paul Kilford
Sent: Friday, April 12, 2019 4:46:18 PM
To: s9(2)(a)
Cc: Emma Grigg
Subject: Speaking notes

[SENSITIVE]

Hi Paul

We can put these into a tidier form if you like but below are what we thought would be some useful notes for MoR on the TPWP (given it features so heavily in the Cabinet paper recs):

- The Tax Policy Work Programme is periodically refreshed (at the commencement of and half-way through each Parliamentary term) to make sure it is addressing the priorities of the Government
- The next refresh is due in the middle of this year
- The TWG conducted a thorough review of the entire tax system
- Having a comprehensive list of recommendations from the TWG will greatly help with the refresh process
- Before the TPWP is finalised, there is extensive internal and external consultation to ensure that the views of relevant stakeholders are considered
- Potential items for inclusion are prioritised having regard to:
    - the Government's fiscal and revenue strategies
    - broader policy objectives, including the integrity of the tax system
    - policy resource constraints, including resources necessary to complete existing work that is moving through the consultation and legislative phases
- The final TPWP is jointly agreed by the Minister of Finance and the Minister of Revenue, with the proposed programme being brought back to Cabinet for noting.

Do these look OK to you? According to my diary the meeting with the MoR isn't until the end of the day but if you need anything from us before Cabinet please let me know on Monday morning (Emma is on leave, so I can be first point of contact.

Cheers
Paul

Paul Kilford | Policy Manager | Inland Revenue
s9(2)(a)
E. paul.kilford@ird.govt.nz | W. www.ird.govt.nz

From: ^IRD: Paul Kilford
Sent: Tuesday, 16 April 2019 4:11 PM
To: ^Parliament: Keiran Kennedy
Cc: Mark Vink [TSY]; Jordan Ward [TSY]; ^IRD: Phil Whittington
Subject: TWG response

[SENSITIVE]

Hi Keiran

A couple of things:

- At the end of this email are some lines on the "less than full residential option". Let me know if you need anything further on this.
- For the announcement, we understand that Ministers will be releasing the table at the back of the Cabinet paper as part of their PR. We will update the tax policy website to include an item that would just something like: "Today the Government released its response to the recommendations of the Tax Working Group. The response to individual recommendations can be found here [with link to the Ministers' PR/table]" This would go up immediately after the Ministers' PR goes live.

Cheers
Paul

- The minority itself could not agree with whether second homes/baches should be taxed.
- If second homes/baches are not taxed:
  - the additional revenue from taxing rentals is reduced
  - it raises significant efficiency concerns because you would tax someone on capital gains if they rent the home to someone, but not if they keep it empty for most of the year. In other words, the tax system would favour someone that left a house empty rather than renting it – and this could create negative housing supply effects
  - it similarly raises fairness concerns because the system would reward those that could afford not to rent their second home
  - you have all sorts of definitional problems of deciding when a property is a bach (what if it's on Airbnb most of the year?) or a rental. This increases complexity and compliance/administration costs.
- If you try to make the exemption simpler, by allowing anyone to own one additional property without capital gains tax (which could be a bach or a rental), you end up:
  - collecting no significant revenue
  - favouring small-scale over professional landlords
  - creating compliance costs from needing to nominate an exempt property if you own more than one
  - having to retain the bright-line rules in order to prevent speculation (otherwise people could use their one additional property allowance to buy and sell quickly for a profit).
- The combination of the above supports the status quo over a watered down tax on capital gains from residential rental property.

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