



**Tax policy report: Options for extending taxation on capital gains**

<b>Date:</b>	6 March 2019	<b>Priority:</b>	High
<b>Security level:</b>	Sensitive - Budget	<b>Report number:</b>	IR2019/132 T2019/618

**Action sought**

	<b>Action sought</b>	<b>Deadline</b>
Minister of Finance	<b>Read</b> before your meeting on 7 March	7 March 2019
Minister of Revenue	<b>Read</b> before your meeting on 7 March	7 March 2019

**Contact for telephone discussion (if required)**

<b>Name</b>	<b>Position</b>	<b>Telephone</b>
Matt Benge	Chief Economist Inland Revenue	s9(2)(a)
Mark Vink	Manager, Tax Strategy The Treasury	

6 March 2019

Minister of Finance  
Minister of Revenue

## **Options for extending taxation on capital gains**

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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.

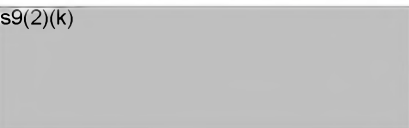
## **Recommended Action**

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We recommend that you:

a **read** this report before your meeting on Thursday 7 March.

s9(2)(k)



**Mark Vink**  
Manager  
Tax Strategy, The Treasury

s9(2)(k)



**Matt Bengel**  
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

	<b>Comprehensive taxation (TWG option)</b>	<b>Small business and other targeted relief</b>	<b>Partial inclusion</b>	<b>All Land</b>	<b>Residential rental or residential rental plus second homes only</b>
<b>Description</b>	<ul style="list-style-type: none"> <li>Taxation of most assets at full marginal tax rates</li> <li>Capital losses deductible</li> <li>Roll-overs for business reorganisations</li> <li>Lower rate on capital gains at retirement for small businesses and farmers</li> <li>Reinvestment roll-over for small active businesses</li> <li>Roll-over at death</li> </ul>	<ul style="list-style-type: none"> <li>Taxation of most assets</li> <li>Same reliefs as TWG report</li> <li>Targeted measures to relieve taxation in some circumstances</li> <li>Family gifting roll over for small business and farmers</li> <li>Reduced inclusion rate for small businesses and farmers</li> <li>Reduced PIE inclusion rate</li> <li>Annual exempt amount</li> </ul>	<ul style="list-style-type: none"> <li>Taxation of most assets</li> <li>A portion of capital gains and losses of individuals would be subject to taxation</li> <li>At 75%, top rate of tax would be 24.75% similar to Australian rate of 23.5%</li> <li>Same reliefs as TWG report</li> </ul>	<ul style="list-style-type: none"> <li>All land would be taxable</li> </ul>	<ul style="list-style-type: none"> <li>Minority recommendation</li> <li>Would extend capital gains taxation only to residential property</li> <li>Could either include or exclude second homes</li> </ul>
<b>Government's objectives</b>	<b>Ranking Key</b>	<b>✓✓✓ Meets objective</b>	<b>✓✓ Partially meets objective</b>	<b>✓ Less progress relative to other options</b>	
<b>Revenue over 5 years</b>	\$8.3 billion <b>✓✓✓</b>	Depends upon measures <b>✓ or ✓✓</b>	Greater than \$6.2 billion <b>✓✓✓</b>	\$4.3 billion <b>✓✓</b>	\$2.3 billion <sup>1</sup> <b>✓</b>
<b>Progressivity</b>	<ul style="list-style-type: none"> <li>Substantial increase in progressivity</li> <li>Taxing financial and business assets targets increased taxation to upper income earners</li> </ul> <b>✓✓✓</b>	<ul style="list-style-type: none"> <li>Relief for small business could reduce progressivity relative to comprehensive taxation</li> <li>Taxing financial and business assets targets increased taxation to upper income earners</li> </ul> <b>✓✓</b>	<ul style="list-style-type: none"> <li>Substantial increase in progressivity</li> <li>Taxing financial and business assets targets increased taxation to upper income earners</li> </ul> <b>✓✓✓</b>	<ul style="list-style-type: none"> <li>Smaller progressivity benefit</li> <li>Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed</li> </ul> <b>✓✓</b>	<ul style="list-style-type: none"> <li>Smaller progressivity benefit</li> <li>Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed</li> <li>Given limited tax base and opportunity to change land use, more pass through of tax to tenants</li> </ul> <b>✓</b>

<sup>1</sup> 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.

	<b>Comprehensive taxation (TWG option)</b>	<b>Small business and other targeted relief</b>	<b>Partial inclusion</b>	<b>All Land</b>	<b>Residential rental or residential rental plus second homes only</b>
<b>Horizontal equity</b>	<ul style="list-style-type: none"> <li>Greater improvement</li> <li>More closely aligns capital income taxation to taxation of other income</li> </ul> <p>✓✓✓</p>	<ul style="list-style-type: none"> <li>Specific measures reduce horizontal equity relative to comprehensive taxation of partial inclusion</li> <li>For included activities, more closely aligns taxation of other income</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Greater improvement</li> <li>More closely aligns capital income taxation to taxation of other income</li> </ul> <p>✓✓✓</p>	<ul style="list-style-type: none"> <li>Modest improvement</li> <li>Evens out taxation land with fully-taxed assets</li> <li>Under-taxation of capital gains on business and share assets remain</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Least of options</li> <li>Evens out taxation of residential real estate with fully-taxed assets</li> <li>At the same time means harsher treatment for residential real estate than most other appreciating assets.</li> <li>Under-taxation of capital gains on business and share assets remain</li> </ul> <p>✓✓</p>
<b>Efficiency and Productivity</b>	<ul style="list-style-type: none"> <li>Capital gains taxation raises tax on capital income reducing incentive to invest and productivity</li> <li>By itself, likely to reduce efficiency and productivity although net effect with business package could be productivity enhancing</li> <li>Removes tax bias across activities with different percentage of capital gains</li> <li>Lock-in effect</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Depends upon measures</li> <li>Significant measures can distort activity</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>By itself, increases tax on business activity although net effect with business package could be more balanced</li> <li>Removes tax bias taxation across activities with different percentage of capital gains</li> <li>Reduced lock-in effect</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Would be a relatively efficient tax since land in fixed supply</li> <li>Under-taxation of capital gains on business and share assets remain</li> <li>Lock-in effect on taxed assets</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Like land tax, relatively efficient (non-distorting) source of revenue</li> <li>Evens out taxation of rental residential real estate with fully-taxed assets</li> <li>Lock-in effect on taxed assets</li> </ul> <p>IRD ✓✓ Treasury ✓✓✓</p>
<b>Sustainability</b>	<ul style="list-style-type: none"> <li>Broadening tax base and removing untaxed income improves sustainability of tax base.</li> <li>Most robust if divergence between company and personal tax rates increases</li> </ul> <p>✓✓✓</p>	<ul style="list-style-type: none"> <li>Depends upon measures</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Broadening tax base and removing untaxed income improves sustainability of tax base.</li> <li>More robust if divergence between company and personal tax rates</li> </ul> <p>✓✓✓</p>	<ul style="list-style-type: none"> <li>Broadens revenue base</li> <li>Does not respond to divergence in tax rates</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Broadens revenue base</li> <li>Does not respond to divergence in tax rates</li> </ul> <p>✓</p>

	<b>Comprehensive taxation (TWG option)</b>	<b>Small business and other targeted relief</b>	<b>Partial inclusion</b>	<b>All Land</b>	<b>Residential rental or residential rental plus second homes only</b>
<b>Integrity</b>	<ul style="list-style-type: none"> <li>Reduces scope for companies to be used to shelter income from higher rates of personal tax</li> <li>Stops conversion of income into capital gains</li> <li>Reinforces fairness and sustainability gains</li> </ul> <p>✓✓✓</p>	<ul style="list-style-type: none"> <li>Depends upon measures</li> <li>Would improve integrity if dividend avoidance discouraged</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Reduces scope for companies to be used to shelter income from higher rates of personal tax</li> <li>Some incentive for conversion of income into capital gains</li> <li>Reinforces fairness and sustainability gains</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>No effect on integrity outside of labour component of real property</li> <li>Need for rules for land-rich companies</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>No effect on integrity outside of labour component of rental residential housing appreciation</li> <li>Need for rules for land-rich companies</li> </ul> <p>✓</p>
<b>Complexity</b>	<ul style="list-style-type: none"> <li>Increases compliance costs for all taxpayers earning capital gains</li> <li>Valuations of existing assets when tax comes into effect complex especially for business assets and private shares</li> <li>Complex adjustment for shares of members of corporate groups</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Similar to comprehensive</li> <li>Targeted measures can add considerable complexity</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Similar to comprehensive</li> <li>Depends upon size of discount</li> <li>Need to distinguish between capital gains and income for individuals (not as difficult as for companies)</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Smaller increase in compliance costs</li> <li>Adds need for land-rich company rules and valuation of land on sale of business</li> <li>Still need business roll-overs</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Much smaller increase in compliance costs</li> <li>Increases compliance costs for landlords or landlords plus those with second homes.</li> <li>Valuations of existing assets less complex than other business assets and private shares</li> </ul> <p>✓✓✓</p>
<b>Coherence</b>	<ul style="list-style-type: none"> <li>More coherent due to more comprehensive definition of income</li> </ul> <p>✓✓✓</p>	<ul style="list-style-type: none"> <li>Targeted measures can compromise coherence</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>More coherent due to more comprehensive definition of income</li> </ul> <p>✓✓</p>	<ul style="list-style-type: none"> <li>Leaves fundamental incoherence of exempting a portion of income</li> </ul> <p>✓</p>	<ul style="list-style-type: none"> <li>Leaves fundamental incoherence of exempting a portion of income</li> </ul> <p>✓</p>
<b>Other concerns</b>		<ul style="list-style-type: none"> <li>Likely to encourage calls for more and more targeted measures, which undermines the tax base.</li> </ul>	<ul style="list-style-type: none"> <li>Could be seen as some allowance for impact of inflation on capital gains.</li> </ul>	<ul style="list-style-type: none"> <li>Maintains preferential treatment for some forms of saving and investment, but targets saving through land, which raises fairness issues.</li> <li>Appears to target farmers</li> </ul>	<ul style="list-style-type: none"> <li>Maintains preferential treatment for some forms of saving and investment, but targets saving through residential property, which raises fairness issues.</li> <li>Adds to a number of measures that increase the tax or regulatory burden on residential property investors</li> <li>Likely to have the largest pass-through to tenants of all options.</li> </ul>