Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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The advice represents the preliminary views of the member/s who prepared the paper and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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MINORITY VIEW INSERT INTO CHAPTER 5

For: Tax Working Group

From: Robin Oliver, Joanne Hodge
Kirk Hope

Date: 14 December 2018

Re: Summary insert for Chapter 5

NB this has been prepared in advance of the revised Chapter 5 and so it might need some consequential amendments to fit within that content. This condenses our paper into the main points for inclusion in the appropriate place in Chapter 5 (after the summary for the majority).

Minority Views

The Group was asked to consider a system for taxing capital gains that would improve the tax system. In order to evaluate whether such a system would be an improvement or cause damage to New Zealand's current tax system, the rules needed to be devised and then evaluated within the time available. *[These opening sentences could go elsewhere in Chapter 5 as they are generic.]*

It is the view of three of the Group (Robin Oliver, Joanne Hodge and Kirk Hope) that the comprehensive approach to taxing remaining untaxed capital gains in New Zealand would impose efficiency, compliance and administrative costs that would not be outweighed by increased revenue, fairness perceptions, and possible integrity benefits. Our specific concerns follow.

Tax system should not impede experimentation and innovation

New Zealand needs to respond to demographic, technological and global economic change. Businesses must take risks and be encouraged to experiment with new ideas and methods; entrepreneurship and experimentation should be encouraged and not penalised. New Zealand's tax system should not impede this. In our Terms of Reference the Government confirmed its view that our tax system should operate neutrally and as much in the background as possible and we agree with this. It can be seen from the circumstances noted below that the proposed capital gains taxing system will impose new impediments to innovation and is likely to distort investment decisions in more instances than at present.

Residential rental housing

We agree that there is a case for taxing more gains from residential rental property, based on advice from officials that the taxable income from such properties is low when compared with total economic returns. Comparing taxable income returned from this asset class with a rate representing a risk-free return applied to the same asset class indicates owners are relying on tax-free gains to complement their taxable returns from that investment.

We accept the view from officials that there is a possibility that part of the incidence of any additional tax could flow through to higher rental costs. Given constrained supply of housing (through land supply, regulation and inadequate infrastructure) it is possible that this could lead to a reduction in the value of houses as well. However, the impact of imposing additional tax on housing will be only one aspect to be considered by Government in its policies aimed at rectifying housing unaffordability.

If gains from residential property are to be more fully taxed, then this could be done with some modifications by extending current rules, including the bright-line tests (and the

proposed rules contained in Volume II that deal with housing could be used as a basis to amend the current bright line tests). Alternatively, we consider that a simpler option could be to apply the risk-free return method, or something similar, to residential housing. This method taxes net equity in an asset at a fixed rate each year.

Extending the tax base in this more limited way would generate much of the revenue expected from the comprehensive capital gains tax contained in Volume II. Officials estimate that some 39% of the total revenue from a capital gains tax would be from residential houses over a 10 year time period[1].

Other asset classes

The incremental approach of extending the tax base carefully over time has served New Zealand well over many of years of tax reform. However, extending the taxation of capital gains to the additional asset classes referred to below in accordance with our proposed capital gains tax system (having regard also to the proposed timeframe for enactment of the legislation) is problematic.

Other land and buildings, businesses and goodwill

Land and buildings (other than residential rental) can be inextricably integrated with business activities conducted on or within them. Taxing gains on business assets, including goodwill, gives rise to an increasing need for roll-over reliefs and exceptions which are intended to reduce lock-in impacts and compliance costs, but can cause the reverse. It can be seen from the rules we have designed that there will be complexity, high compliance costs and inconsistent rules and these are characteristic of many overseas capital gains tax systems.

The need to value business assets such as goodwill and other intangible assets on introduction date is one illustration. Valuing such property is likely to impose high compliance costs on businesses. It could also impose an unacceptable fiscal risk to the government (even with the proposed median rule). The response is to ring fence capital losses following from the valuation day cost base of these assets coming into the regime and this imposes a tax penalty on the experimental activity New Zealand needs to encourage. These particular rules are necessary to protect the tax base but they would directly impede experimentation and innovation.

Taxing share gains

Taxing both business asset gains and share gains could create double taxation and potentially double deductions. Complex rules are required to counter the latter and the former would create a comparative tax penalty on New Zealanders owning shares in New Zealand companies, as compared to the proposed tax treatment of foreign shares (under the fair dividend rate method).

A comprehensive tax on capital gains requires a redesign of current tax rules applying to KiwiSaver and other Portfolio Investment Entities (**PIEs**), changing the current relatively consistent tax treatment of investors irrespective of the entity through which investments are made. Such inconsistency risks damage to New Zealand's capital markets. Additionally, taxing KiwiSaver and PIEs on Australasian share gains on an accrual basis and requiring the government to cash out accrued losses will create a significant fiscal risk to the government. Not to do so would impose a tax penalty on KiwiSaver and other PIE investors.

The proposed capital gains tax system on shares increases the tax on New Zealand owners of shares in New Zealand companies while, because of our double tax agreement obligations, foreigners owning New Zealand shares would mostly have no tax increase. The same would apply to New Zealanders owning foreign shares. While the reasons for these as explained in Volume II are valid, the outcome is clearly adverse.

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[1] $0.18b out of a total of $0.59b in year 1 (30.5% of total CGT forecast) through to $2.4b out of a total of $6.2b in year 10 (39% of total CGT forecast in that year)

While there is evidence that residential rental properties are under-taxed there seems little to suggest that overall, New Zealand companies or shareholders, with the possible exception of land rich companies, are taxed at less than full economic income in the same way that residential rental properties are undertaxed.

Revenue to be raised

The extra revenue forecast to be raised from the more comprehensive approach to taxing remaining gains seems relatively low, reflecting the additional fiscal risks the Government would assume. In taxing gains from business assets and shares the Government would assume a proportion of what has been private sector risk; the Government simply assumes a proportion of investor risk and in return receives as tax revenue a proportion of investor gains. The Government could assume the same risk and extra revenue by investing directly in the share market.

Conclusion

We agree that gains from residential rental property could be more fully taxed. Existing rules can be amended or more targeted rules introduced to achieve this.

The fairness benefits from extending the proposed capital gains taxing system to other assets are likely to be overstated, especially given the exclusion of the family home set by our Terms of Reference. Our current tax system is relatively simple and efficient. It does not overly impede the type of experimental behaviour to be encouraged in the future. In our view it would be preferable to amend some current rules (residential rental homes) and to better enforce existing rules. For example, a study received by the Group[2] estimated that the hidden (untaxed) economy from underreporting of income by self-employed (on average, 20% of their gross income) could raise approximately $850 million per annum. Countering tax evasion and properly enforcing rules already in place relating to property gains seems more sensible than introducing a new comprehensive capital gains tax system with high revenue risks and relatively moderate additional tax revenue to be collected over the forecast period.

For the reasons above it is our judgment that the disadvantages of the comprehensive capital gains taxing system we have worked on with the Group outweigh the advantages and it should not be implemented.

[2] Cabral, A. C., & Gemmell, N. (2018). Estimating self-employment income-gaps from register and survey data: Evidence for New Zealand. Wellington: Victoria University Press.