Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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To: The Tax Working Group

From: Nigel Barak

Date: 30th April 2018

I would like to make the following submission in response to the Tax Working Group's invitation to New Zealanders to "have your say" in relation to tax reform. There is a summary below and in the pages that follow, I have set out the more detailed arguments that support these proposals. My submission falls under four headings;

- "Fairness"
- New Zealand's 'broad-based, low-rate' system
- Taxes and behaviour
- Housing affordability, Capital Gains Tax and Land Tax

In summary:

"Fairness". In **Chapter 3: *"Purposes and principles of a good tax system"*** you raise the issue of "fairness".

"Fairness" is a recurrent theme throughout your consultation document – and quite rightly so. The concept of fairness is fundamental to any discussion about taxation. Our problem in discussing fairness is that it is too easy to rush to a subjective judgement. We must avoid this, as otherwise we will never get a consensus view on what this cardinal concept actually means in practice.

Put another way; unless we can agree on what we mean by "fairness", we cannot even start the debate about tax reform. It is that important.

In the Living Standards Framework, you set out the concepts of *horizontal equity* and *vertical equity* – both conceptually simple ideas and both helpful. I would like to add three strictly practical tests that I think are pre-requisites for "fairness":

- Simplicity – can it be easily explained and understood?
- Clarity – is it unambiguous?
- Practicality – is compliance straightforward?

I have fleshed out the arguments behind this summary in **Appendix 1**

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In Chapter 4: ***"The current New Zealand tax system"***, you ask for feedback on two subjects on which I would like to respond.

First, on **New Zealand's 'broad-based, low-rate' system:**

Yes, I do think that our broad-based, low rate system should be maintained. I think it sends an important message that everyone who earns an income should make a contribution to government, however small, as should everyone who consumes.

Our progressive income tax system and low rates mean that we can achieve "vertical equity", whilst keeping all income-earners and all consumers in the same boat. We should keep to this philosophy

Second, on **Taxes and behaviour:**

You ask: "Should there be a greater role in the tax system for taxes that intentionally modify behaviour? If so, which behaviours and/or what type of taxes?"

Here, I want to talk about our behaviour in relation to **debt**: The factors that influence the choice between debt and equity; how tax policy has shaped the outcome that we see today and how proposed new taxes would impact our preference for debt over equity

The fact is that we are drowning in debt – private debt, not Government debt. Data from the Reserve bank of New Zealand shows that household debt has increased from 100% of disposable income in December 1998 to 168% in December 2017. (In contrast, New Zealand Government debt is much lower relative to GDP than most other OECD countries)

While a large part of total household debt is mortgage debt on the family home *(and therefore, I assume, falls outside the Tax Working Group's remit)*, there is still plenty of household debt that is financing investment and other activities – especially investment property. The points that follow relate to household debt other than mortgage debt on the family home. While my focus is on household debt, many of the same arguments apply to corporate debt

My contention here is that existing tax policies subsidise debt (by allowing the tax-deductibility of debt interest) and penalise equity capital (by taxing savings income). In doing so, they reinforce an existing bias towards debt that comes out of the relative ease of access to debt capital in today's market, as compared to equity capital – particularly for individuals.

The new proposed capital gains tax, if enacted without changing the existing debt subsidies, will push this bias even further towards favouring debt over against equity. I have summarised this contention in the table that follows

Factors that shape our behaviour towards debt vs. equity

Factor shaping behaviour	Debt/borrowings	Equity capital/savings
Lead-time needed to access enough to make a "significant" difference	Days to weeks	Years to decades
How to access	Pick up the 'phone/go online /walk into a bank. We are surrounded by offers of debt and by the positive marketing images of the financial sector	Requires sustained self-discipline & sacrifice - <u>not</u> spending money earned - to accumulate equity savings
Present tax policy	Subsidises the cost of debt and as a result, drives up property prices and increases wealth disparity	Taxes the income from savings.
Proposed capital gains tax, wealth tax	Would increase the demand for debt, as CGT reduces the availability of savings. Amplifies the effect of existing tax policy	Additional tax on savings is a further disincentive to keep to the discipline of saving
Long term impact on society	Excess debt risks default, Banks become "too big to fail". The world's economy becomes excessively financialised. The next credit crisis will be worse than the last one	Excess savings makes default a non-issue. Savings reduce individuals' dependence on the state in later life. Domestic savings reduce our dependence on foreign debt capital

In summary, I would like to propose that the Government should recognise that **<u>debt</u>** is an addictive product that has simply never been on the radar for these discussions, despite the fact that millions of New Zealanders spend more of their income on it than they do on any of the products that we traditionally regard as "addictive"

In contrast, **<u>savings</u>** (of all kinds, not just "retirement savings") are the opposite of debt. I suggest that Government should <u>encourage</u> savings to start to wean us off our addiction to debt, rather than add to the tax burden on savers, which will drive us further into debt

I have fleshed out the arguments behind this summary in **Appendix 2**

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<u>Housing affordability, Capital Gains Tax and Land Tax</u>. You ask about these in **Chapter 7: *Specific challenges***. Taking these in turn:

<u>On housing affordability</u>: Introducing a capital gains tax (excluding the family home) will **<u>not</u>** improve housing affordability. Other measures to improve housing affordability are subject to the law of unintended consequences and may well achieve a result other than that intended.

Here we can learn some lessons from the UK experience:

- The UK has had a capital gains tax (excluding the family home – just like the model proposed here) for over 50 years, and houses there are as unaffordable as they have ever been.
- In recent years, this problem became so acute that the government of the day introduced a "Help to Buy" scheme, in which they offered an interest-free 5-year "equity loan", specifically to try to make housing more affordable to first-time buyers. As the IMF pointed out at the time, fresh government money entering the housing market pushed up the prices of existing houses and development land, benefitting existing homeowners and property developers, rather than those it was intended to help.
- The lesson from this is an old one: "the road to hell is paved with good intentions". The role of Government in housing is to pay for, or to provide housing for those who cannot afford it themselves, but not to meddle with the housing market

<u>On the proposed capital gains tax</u>: I have already argued that a capital gains tax would be a tax on behaviour we should encourage, not deter

If, however, the Tax Working Group decides that we have to have a CGT regardless of this point, you have asked for submissions on its design. My detailed submission is set out in Appendix 3, but in summary:

- CGT should be a separate tax, not "income tax"
- It should be levied on realised gains, not accrued gains
- Roll-over relief should be allowed
- Matrimonial property settlements should be covered by roll-over relief
- Death should not trigger a CGT event
- Collectibles and private assets should be excluded on grounds of practicality
- Allowing CGT exemption to KiwiSaver and other savings vehicles would distort investment markets. It would be "fair" for some lucky savers, but unfair for others, whose savings happen to be in assets that cannot readily be transferred into permitted tax-exempt vehicles. It is potentially a minefield

- Assets held offshore should be taxed equally to New Zealand-held assets. Returning to the previous point, if tax-exempt vehicles are to be allowed, it should be possible to transfer assets held offshore into them
- If a CGT is introduced, it should replace all existing tax structures on the assets covered by the CGT
- Non-residents should not be subject to New Zealand CGT, subject to renegotiating existing double taxation treaties
- CGT losses should be ring-fenced against future capital gains without limit in time
- Emigration should not trigger a CGT event. This would be a tax on emigration
- Immigrants should be allowed a grace period before any CGT applies to assets held at the time of immigration
- The tax rate on CGT should be lower than the marginal income tax rate, to minimise the disincentive to save. It should be a flat rate of 15%, with a zero-rate band to encourage savers to get started on their journey.
- Indexation of the purchase price used in a CGT should be allowed so as to avoid forcing taxpayers to pay real tax on illusory gains
- There should be a *de minimis* rule – see above
- The administrative implications are considerable and wide-ranging. A CGT can simplify the existing tax structure only if it replaces all tax regimes that currently apply to capital assets. If it becomes an additional tax regime, it merely adds complexity to a massively complex existing tax regime covering capital assets. It will also be necessary to re-think the provisional tax regime if CGT is to fall within it
- The transition to a CGT should be via the “Australian Rule”

Finally: <u>Land Tax</u> (excluding the land under the family home)

It is not clear how this might be applied, so:

- If a land tax were to operate like a wealth tax (i.e. like council rates), it would trigger tax payments far ahead of any income from which they could be paid (maybe decades ahead in this case). This would undermine “fairness”
- If a land tax were to operate like a CGT, then I would reiterate my observations on CGT above. I would add that a land tax, if applied in isolation, would discriminate against one type of investment asset and therefore distort investors’ choices about where to place their investments – not a desirable outcome.

I have fleshed out the arguments behind this summary covering housing affordability and capital gains tax in **Appendix 3**

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The detailed arguments that underpin these conclusions are set out in the appendices that follow

Appendix 1

Defining 'fairness'.

In **Chapter 3:** ***"Purposes and principles of a good tax system"*** you raise the question of fairness. The concept of fairness is central to the Tax Working Group's questions for submitters.

However, whilst it is easy to come up with a subjective definition, this would leave "fairness" as purely a matter of opinion – not a good start if we want to finish up with a consensus view

To avoid subjectivity, let us ask what practical pre-conditions have to be met for a tax regime to be "fair"? I think there are three:

- Simplicity – can it be easily explained and understood?
- Clarity – is it unambiguous?
- Practicality – is compliance straightforward?

We can apply these criteria to ask how well the existing tax regime performs

Simplicity

In my view, where the existing tax system is simple, it qualifies as "best in class". However, where it is complex and lacks clarity, it falls far short of this description.

Tax on income from employment and GST are simple taxes that are easily understood. However, tax on investment income can be quite the opposite. Someone who is saving for retirement and has sensibly invested their savings in a diversified mix of different types of investment can potentially be subject to tax under at least 9 different tax regimes of which I am aware:

- The "Financial Arrangement" rules
- The "Comparative Value" (CV) method, if investments fall under the "Foreign Investment Fund" (FIF) regime
- The "Fair Dividend Rate" (FDR) method, as an alternative to the CV method above, within the FIF regime
- The "Quick Sale" adjustment (applicable to the "Fair Dividend Rate" method, but not to the "Comparative Value" method).
- The "Australian Exemption" rules
- The rules that govern the definition of "fixed rate shares"
- The rules governing the tax credits that can be claimed for foreign tax deducted at source when using the FDR method within the FIF regime

- The slightly different rules governing the tax credits that can be claimed for foreign tax deducted at source when using the CV method within the FIF regime
- The rules governing taxation on sales of land or property

Different rules apply to investments held directly by an individual, as compared to those held via a Collective Investment Vehicle (CIV), such as a KiwiSaver or other savings vehicle. Thus, if an individual wishes to hold foreign investments as part of their retirement savings, the same foreign investments held for the same purpose by the same individual could have quite different tax outcomes if held directly, versus if held via a CIV.

There is no way that this morass of complexity (and matching acronyms!) could ever be called "fair" – it falls flat on its face when measured against the criterion of simplicity. It also runs contrary to the principle of *"horizontal equity"* (fair treatment of those in similar circumstances) set out under the Tax Working Group's heading: "Purposes and principles of a good tax system"

In practice, the detailed working of the FIF regime for individuals is so complex that I have encountered some tax practitioners who simply refuse to take on a client whose tax return involves the FIF regime.

Complexity of this sort drives up the cost of compliance, as well as potentially fertilising mistakes, so I would urge that complexity be explicitly recognised as the polar opposite of "fairness" when it comes to tax design

With this in mind, I would like to suggest a criterion for tax reform with reference to individual taxpayers. *Simplicity* requires that:

Any tax to be paid by individual taxpayers should be readily understandable by a reasonably literate and reasonably numerate taxpayer, without the need for expert advice and/or interpretation

I refer to individual taxpayers here, because I recognise that corporate (and perhaps, Trust) taxpayers may have complex income structures that require specialist advice.

Clarity

In its briefing to submitters, the Tax Working Group has said that "One important aspect…is to provide as much certainty to taxpayers as possible as to what tax is due".

There can be no doubt that certainty as to what tax is due is essential to any definition of "fairness".

However, clarity about tax outcomes is completely undermined by retrospective changes to tax policy.

From time to time, the IRD changes its view about the tax treatment of particular types of asset and issues a tax determination that applies retrospectively. Thus, a taxpayer who might have thought that they had settled their tax affairs for previous years correctly, given the best available advice at the time, now suddenly finds that they have not.

Such retrospective determinations undermine any certainty that taxpayers may have as to what tax is due.

Retrospectively-determined taxation should simply not be allowed. It undermines any notion of "fairness". If the IRD decide that the interpretation they have historically been applying to a particular type of income or asset was wrong, they should be able to change their determination for the current and future years, but not retrospectively.

The taxpayer has to "wear" the cost when the taxpayer gets it wrong (though UOMI interest and/or penalties), and so should the IRD when the IRD decides that it has got it wrong - or has been less than clear in the past - if "fairness" is to be achieved.

Practicality

Is compliance straightforward? One practical test of "fairness" in tax design is to ask - can taxpayer in practice, pay the tax that they owe?

If tax is charged ahead of the receipt of the taxable income on which it is calculated, compliance may become quite impractical. That is why, later in this submission, I argue that a capital gains tax should only ever arise on realised gains (i.e. not on an accrual basis). When tax is charged ahead of the income from which it is derived, the taxpayer is forced to sell some assets. This cannot be "fair".

The same principle applies to any wealth tax. A wealth tax would become payable regardless of the taxpayer's ability to fund the tax due. Thus, it cannot be "fair". The same would be true of a land tax, if it were to operate in the same way as a wealth tax

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Appendix 2

<u>Modifying behaviour.</u>

In Chapter 4: The current New Zealand tax system, you ask *"Should there be a greater role in the tax system for taxes that intentionally modify behaviour? If so, which behaviours and/or what type of taxes?"*

Traditionally, this subject refers to raising taxes on addictive products, such as tobacco and alcohol and more recently, on sugar, to deter what we see as socially "undesirable" behaviour.

However, tax policy also shapes our behaviour towards **<u>debt</u>** and has contributed to the fact that millions of New Zealanders now spend more of their income on it than they ever do on any of the products that we traditionally regards as "addictive".

As set out in the summary, the points that follow relate to household debt <u>other</u> than mortgage debt on the family home. While my focus is on household debt, many of the same arguments apply to corporate debt

Several factors contribute to our addiction to debt over equity:

- The lead-time to access debt finance, vs. equity.

  - Debt: The financial services sector makes sure that we live our lives in a deluge of their marketing – they are extremely keen to extend credit to borrowers and this is reflected in the short lead-times to get a loan for any creditworthy borrower
  - Equity: The hard graft of saving to create an equity stake that can then be invested looks like a long, hard, slow road to travel and in comparison to borrowing, it is. It can take years or even decades to save as much as can be borrowed in days or weeks. In comparison to savings, debt has become the route to "get rich quick"

- How to access debt, vs. equity

  - Debt: There are many channels to access debt. Lenders make it as straightforward as they can
  - Equity: There is only one way to accumulate equity by saving. It requires sustained self-discipline - <u>not</u> spending money to build up equity capital

- The impact of present tax policy

- Debt: Tax relief on debt interest subsidises the cost of debt. As a consequence of debt being cheaper, borrowers can take on more of it than they could in the absence of tax relief. This means that more money is available to chase up the price of investment assets that can be debt-financed. Thus tax relief on debt underpins high property prices. Further, it drives up inequality of wealth because our progressive tax regime gives a bigger subsidy to borrowers on higher tax rates – i.e. to those whose taxable income is higher
- Equity: Income from savings is taxed, slowing the rate at which reinvested income can build capital. On this, let me be clear, I am not suggesting that savings income should be taken right out of the tax net. However, I am making the point that present tax policies, given the differences in tax treatment between debt and equity, push us towards the warm embrace of the banks

- The proposed capital gains tax would further amplify the incentive that the existing tax system offers to favour debt over equity
- The long term impact on society. This heading refers to the different consequences of our preference for debt over equity, rather than to its causes

  - Data from the RBNZ show that household debt (relative to disposable income) is at record levels and is higher now than it was in the run-up to the global financial crisis of 2008/09. This relative level of debt cannot continue to rise indefinitely – financial chaos would inevitably follow. The Tax Working Group has an opportunity re-think how tax policy influences our attitude to debt
  - I cover the impact of tax policy on savings in more detail below.

<u>On retirement savings</u>, you ask: "**s**hould the tax system encourage saving for retirement as a goal in its own right? If so, what changes would you suggest to achieve this goal?"

The Tax Working Group makes the point that predictable demographic shifts will stretch the ability of the Government to finance the needs of an ageing population.

There is a hidden public benefit of private savings that seems to have attracted little comment so far. It is simply that an individual who has provided for their retirement through their savings is likely to be less dependent on the state than someone who hasn't. They are less likely to need (or to qualify for) welfare support and more likely to be able to fund or contribute to their own medical care and aged care in later life.

Once we accept that private savings can actually contribute to the "public good", we begin to see savings in a different light.

It seems to me that the best role that Government can play is simply to "get out of the way". If more taxes are imposed on savers, less will be saved. If the tax burden on savers is reduced, more will be saved. It is really as simple as that.

Here, I am not suggesting that we should take savings income (e.g. interest or dividends) out of the tax net altogether. My proposition here is that any discussion about additional taxes on savings needs to take into account our existing high levels of debt and how increased taxes on savings will affect this

Let me add that savings does not have to be "for retirement". There can be reduced dependency on government well before retirement – e.g. if someone who has accumulated some savings finds themselves temporarily out of work, they may be less immediately dependent on Government support than someone who has not a dollar of savings to fall back on, so any question about how the tax system could "encourage saving" should not be restricted to saving "for retirement"

I will cover the practical implications for this in the section below on the proposed Capital Gains Tax

In summary, my response under this heading is that the bias of the present tax system is to favour undesirable outcomes by subsidising debt whist taxing savings. Over many years, this has led to an addiction to debt.

When you think about it, we seem to have got our attitude to debt and savings the wrong way round

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Appendix 3

Under Chapter 7: *Specific challenges*, you ask for submissions on

- Housing affordability
- Capital Gains Tax
- Land tax

Taking each in turn:

Housing affordability: "How, and to what extent, does the tax system affect housing affordability for owners and renters? Is there a case to change the tax system to promote greater housing affordability? If so, what changes would you recommend?"

On this, my first contention is that there is good evidence from overseas experience to show that introducing a capital gains tax (on assets other than the family home) will not improve housing affordability.

Prior to immigrating to New Zealand in the early 2000s (one of the best choices I have made in my life, I have to say!), I had been living in the UK for long enough to remember the introduction of capital gains tax back in 1965. As with the model proposed here, this excluded the family home.

Over 50 years later, it is still in place, though over the years, various Chancellors have tinkered with the system. It started with capital gains taxed as income and subsequently switched to become a separate tax with its own tax rates and personal (tax free) allowance. It has gone through periods where purchase costs could be indexed before the capital gain is calculated and other periods were a reduced rate was charged on investments held for longer terms (to penalise short-term trading - this latter provision also applies in the US tax code).

53 years later, housing in the UK is more unaffordable than ever – so much so that in 2013, the Government of the day introduced its "Help to Buy" scheme, in which the Government offered first-time buyers an interest-free 5-year "equity loan".

Thus, the UK experience demonstrates that a capital gains tax will do nothing for housing affordability

So if a CGT won't help, what can we learn from what is now a 5-year-old experiment in direct intervention by government in the UK housing market to improve housing affordability?

Unfortunately, the learning experience here is a model of how government intervention in the housing market can so easily misfire. Soon after its launch, the IMF expressed concern that the pressure of additional funds entering the first-time buyer market was inevitably going to raise the price of existing houses and building land and therefore benefit existing homeowners and property developers to the disadvantage of those who weren't already homeowners.

This is exactly what has happened. "Help to Buy" has therefore achieved largely the opposite result of that intended, but it has left a number of new homeowners with 90% mortgages at a time when the original 5 year subsidy will come to an end and interest rates look set to rise from their 300-year lows.

"Help to Buy" in the UK made good headlines for the Government at the time of its launch but it may well finish up bankrupting at least some of those it was intended to help.

As the old saying goes "the road to hell is paved with good intentions".

The lesson from this is that Government interventions to "promote greater housing affordability" are fraught with risk. Government should stick to its job of providing a housing safety net for those unable to provide for themselves or for their families.

Capital gains Tax (CGT)

The main problem I have with the proposed Capital Gains Tax is that it penalises savers and encourages spendthrifts.

Imagine two siblings, Jack Spendthrift and Jill Saver. They are the same age and start their working careers at the same time, doing identical jobs, with the same pay. This continues to be the case over the next 40 years until their retirement and the only difference between them is that Jack always indulges himself. He likes to take expensive foreign holidays, to be seen in trendy restaurants, and drives a flash new car. He spends every cent he earns and is frequently in debt.

In contrast Jill takes camping holidays in New Zealand, dines out modestly, and drives a 10-year-old car. However, she always makes sure to save 5% of her income into a savings scheme. She is willing to forgo the pleasure of spending money today to provide responsibly for her own and her family's future. She accepts the need for deferred gratification.

40 years later, Jill's parsimony, achieved by not spending all her money, has given rise to a substantial savings pot that she can draw on in retirement. She will be able to live an independent life in retirement and may well not need to call on the government to fund her aged care in later years.

Jack, in contrast has sacrificed nothing for the last 40 years. He will entirely depend on Government support once he retires and will not be able to fund his own aged care

This is the situation before CGT is introduced. Add in a CGT and who pays it?

Jill Saver, of course, but not Jack Spendthrift.

Jill, who has maintained the discipline of saving for the last 40 years and who will be less of a burden on the state as a result, will pay more tax. Jack who has sacrificed nothing and spent selfishly, will be more of a burden on the state in later life, but will face no increase in tax.

In this situation, the principle of "horizontal equity" is completely undermined. "Fairness" goes out of the window and the CGT becomes a millstone round the neck of Jill Saver, encouraging her to behave more like Jack Spendthrift. The higher the rate of CGT, the greater the encouragement to do so.

After all, why make sacrifices and defer gratification when this results in you paying more tax than someone who doesn't. Why should you subsidise their behaviour? Best to spend it all – enjoy life today. The Government will take care of you tomorrow!

This argument – that there is a long-term public benefit arising from private savings – especially when we face a demographic "time bomb", has to be set against the contrary view that whereas income is taxed, capital gains are mostly untaxed today.

In the section that follows, I argue that if there is to be a CGT, then this public benefit from private savings should be reflected in a lower rate of CGT, as compared to income tax rates.

Design Issues for a CGT

The Tax Working Group has asked many questions under this heading. I would like to respond to 16 of them

Should the CGT be a separate tax or part of the income tax?

I think it has to be a separate tax. If CGT were charged at current income tax rates, the progressive nature of income tax means that capital gains would attract the marginal rate for each taxpayer. To the taxpayer, it will seem that their capital gains are being taxed at a higher rate than their income – very discouraging for savers. If we have to have a CGT, the rate should be lower than the top rate of income tax, recognising the value of the lesser burden on the State to be expected from the "Jill Savers" of this world

I would therefore propose a rate of 15% as the "fairest" outcome for Jill Saver

Let me also suggest that this should be a flat rate, rather than a progressive rate, as this is the only way to allow horizontal equity for an investor who only occasionally realises a capital gain. An investor who holds an investment property may only realise a gain after, say 10 years. Another investor who holds exactly the same amount of investment, but in the sharemarket, may realise the same overall gain, but spread over the 10 year period, as shares are held and may be sold in smaller “parcels”. A progressive tax would be more severe on the property investor, all of whose gains fall due in one year, than the on sharemarket investor, even when their overall capital gains are identical.

Further, there has been some discussion of whether there should be a lower rate for gains realised after a longer holding period and a higher rate for short-term gains (as in the US, for example, where “short term” is defined as a year). I don’t think this should be the case. The implication of taxing short term gains at a higher rate is they are somehow “less deserving” of the lower, long term capital gains tax rate. I don’t think that it is the Government’s job to pass judgement on the “quality” of an investment – to say that some are “better” than others simply because they are held for longer.

Should capital gains be taxed on an accrual basis or only when realised (i.e. only when the asset is sold)? …. How should matrimonial property settlements and disposal of assets on death be treated?

Three questions here. First, A CGT should only be charged on <u>realised gains</u>. If it is charged on accrued gains, this brings tax payments ahead of realised income – possibly years ahead. This would force a taxpayer to sell some assets to pay their tax.

At best, this would force the taxpayer to incur additional costs (the cost of selling a small number of shares is high relative to the value realised). At worst, it is impossible. An investor whose only asset is an investment property cannot sell a part of it.

Thus, taxing capital gains on an accrual basis fails the “practicality” criterion for fairness outlined earlier. It can never be “fair”.

[As a footnote, when an accrual basis for CGT was last proposed in New Zealand prior to the introduction of the Foreign Investment Fund (FIF) regime in 2007, it was met by a storm of protest. The present FIF regime was then introduced as a compromise in 2007/08]

As to *matrimonial property settlements* – these should be covered by roll-over relief provisions (covered separately below)

As to *disposal of assets on death*. Death in a family is a major trauma. I used to live in the UK, where Death Duty had always been known as the “cruellest tax”. Just at the time a family is dealing with the shock of a bereavement and the cost of a funeral, the Government steps in demanding money. UK Death Duty has since been re-branded as “Inheritance Tax” in an attempt to overcome this stigma, but the sense of a remote, heartless Government still remains. If CGT were to be triggered on assets sold following a death in the family it becomes a death duty by default. This must not be allowed to happen. The "cruellest tax" is about as far from a "fair" tax as you can get. If a CGT is introduced, there must be an exemption for disposal of assets on death.

What assets should be covered given that the terms of reference exclude any tax on the family home? Should it include just rental properties, shares, collectibles, private assets such as cars?

If a CGT were to include assets like collectibles and cars, The IRD would be forced to make a host of judgements: What is the difference between a pair of earrings that is "collectible", vs a pair that is not? How is the owner to know? Is my 20-year-old everyday car a "collectible", or is my 20-year-old sports car "collectible", because it is not an everyday car?

Including collectible and private assets such as cars would force the IRD to spend their time generating long lists of taxable assets – even more so than they have to do presently under the Australian Exemption rules. The IRD should not have to micro-manage tax outcomes for individual taxpayers in this way.

Thus, collectibles and private assets such as cars should not fall within the scope of any CGT. This may make the CGT less than perfect, but it would at least be practical

One final point here. Going back to my earlier comment about not allowing retrospective taxation; if a CGT is introduced with exemptions for certain items such as collectibles and cars and the IRD later decides it wants to reinstate a particular type of collectible, it should not be allowed to do so retrospectively. At the risk of repetition, retrospective taxes undermine any certainty that the taxpayer has about his tax outcome and should not be allowed.

Should assets held by KiwiSaver and other savings schemes be taxed?

If certain investment vehicles like KiwiSaver and other savings schemes are exempt, but the same investments held outside these vehicles are taxed, this will distort the investment universe. It would cause a rush to sell assets held outside the favoured exempt vehicles and switch them into the exempt vehicles. The beneficiaries of this switch will be the fund managers of the favoured exempt vehicles, whose performance bonuses and ongoing fees will go through the roof (though not because of anything they have done to deserve it)and the losers will be the investors who are caught out by the change in tax policy.

Further, it may be that certain assets presently held outside an "exempt vehicle" simply cannot be switched into one (e.g. foreign shares held directly by an individual or an investment property in Australia, etc.).

Thus, there is a risk that if assets held by KiwiSaver and other savings schemes are not taxed, some investors who are lucky enough to have assets in the “right vehicle” will not feel forced to sell, others, who are holding similar assets for the same purpose, but in the “wrong vehicle” will either have to sell, incurring transaction costs (and perhaps CGT at the time of sale), or will have to accept a tax burden not shared by their luckier brethren.

Thus exempting KiwiSaver and other existing savings vehicles will not be “fair” or equitable

Aside from the practical obstacles to CGT-exemption, there is a conceptual problem here. As the Tax Working Group points out in its briefing to submitters, New Zealand operates on a “TTE” (taxed, taxed, exempt) basis. Exempting KiwiSaver or any other vehicles from CGT would violate this simple principle. What is presently a clear and simple concept could become messy and confused

Should assets held offshore be subject to tax?

There should be no distinction between assets held offshore and assets held in New Zealand

How would a capital gains tax integrate with current tax laws, such as when land sales are already taxable, our company imputation system and our CFC/FDR rules?

For any class of investment asset that is included in the scope of a CGT and that is already taxed, the CGT should entirely replace the existing tax regime. We must not have overlapping, conflicting tax regimes. Simplicity is the objective here

When should non-residents be subject to tax?

Non-residents should not be subject to New Zealand CGT.

New Zealand needs overseas investors as we typically run a budget and trade deficit that leaves us needing to attract capital from overseas. We already have rules and structures in place that protect certain types of New Zealand asset from overseas investors (the OIO for example) and to apply CGT to overseas investors would be a deterrent to investment.

New Zealand also has negotiated a raft of double taxation treaties with other countries. If a CGT was applied to residents of those treaty countries, it would seem that all those treaties might have to be renegotiated.

Should capital losses be ring-fenced to be offset only against capital gains income or should they be offset against any income? If capital gains are taxed on a realisation basis tax base maintenance considerations suggest that capital losses should be ring-fenced.

If CGT is a separate tax (as argued above) and is charged on a realisation basis, capital losses should be ring-fenced against CGT income. It should be possible to carry forward any unused capital losses into future years without limit in time. (I see that there is a current proposal from the IRD to ring-fence taxable losses from property sales against future taxable gains from the same source – the same concept)

If CGT is a separate tax but is charged on an accrual basis, CGT losses should be offset-able against income and any eventual overall loss for the year should be carried forward into future years without limit in time. This recognises that CGT charged on an accrual basis means paying tax ahead of any corresponding cash income. As explained above, I think it would be most unwise.

If CGT is an income tax, CGT losses will be definition, be offset-able against income

Should there be roll-over relief allowing capital gains re-invested in similar assets to be treated as unrealised? If so, when should roll-over relief apply? For example, should a farmer selling a farm and buying a new farm be taxed on the increase in value of the old farm?

Roll-over relief could defer the negative impact of a CGT on savers. If a taxable asset is sold, there needs to be a decent amount of time in which the funds can be reinvested and it should be possible for this reinvestment to be made into a different asset class. It should not be necessary to reinvest in the same tax year, for example and it should be possible to reinvest a capital gain from the sale of a property into some unrelated asset, such as debentures, for example.

As to farms, without roll-over relief, CGT could deny farmers a career in farming. As a farmer migrates up the hierarchy of farms in the course of a career, they have to sell one farm to move up to the next level. If they had to pay CGT at each step, they may well not be able to raise the extra capital to move up to the next level. A CGT without roll-over relief would fall particularly hard on asset-intensive businesses

The key criterion for implementing roll-over relief is that it should be simple to do, for it to be “fair”. No complex rules, please!

How should death, emigration and immigration be handled?

I have covered death above. I believe it should not crystallise a CGT liability, for the reasons already outlined

Emigration. Please can we keep it simple? Emigrants should be taxed under the tax regime of their jurisdiction of residence. Prior to their date of emigration, an emigrant is a New Zealand taxpayer. After that date, they are taxable in their new jurisdiction and subject to whatever New Zealand tax rules apply to residents of that particular jurisdiction.

The act of emigration *per se* does not trigger a capital gain. Thus emigration should not trigger a CGT “event”, as this would then become a straightforward tax on emigration.

Immigration. Is the converse of emigration, though there is a practical problem here, to do with the value of assets held abroad at the date of immigration – in particular, illiquid assets like property that cannot quickly be sold and are expensive or difficult to value. There has to be a transitional period before an immigrant's assets held overseas fall into the CGT net. In the past, this has been 3 years after the year of arrival.

If however, the "Australian Rules" are applied to govern the transition into a CGT, (see my comments under that heading below), this problem goes away. Immigrants would be taxed on gains on assets acquired post-immigration.

Should any allowance be given for inflation in calculating capital gains?

Most definitely yes, the purchase price of taxable assets should be indexed to CPI.

In recent years, inflation has been unusually subdued, but even with a steady 2% inflation, \$100 will grow to \$149 after 20 years or \$221 after 40 years (the savings lifetime of "Jill Saver"). However, the \$149 after 20 years or the \$221 after 40 years will only have the purchasing power of the original \$100. In the absence of indexation, after 20 years, \$49 (49% of Jill's initial capital) would be treated as taxable "income" and after 40 years 121% of her initial capital would be treated as taxable income – more than all of it.

If the inflation rate ticks up just a bit to 3%, it sounds innocuous, but is not at all so in practice. The "capital gain" after 20 years rises from 49% of her initial capital to 81% and over 40 years from 121% to 226%. Such is the power of compounding over many years

These "capital gains" are entirely illusory. If CGT is levied on the money value of assets without indexation, it is simply a tax on inflation. Taxpayers would be forced to pay real taxes on illusory gains. There is no way this could be called "fair"

Should there be a de minimis rule?

Yes, for two reasons. A zero-rate band would mitigate the discouragement that a CGT brings to smaller savers. Returning to the example of "Jill Saver", above, a zero-rate band could keep her out of the CGT net for a few years, but not for ever. The purpose of introducing a CGT is to tax the gains on her retirement savings, so she will in the long run, still pay more tax than "Jack Spendthrift".

Let me suggest that any *de minimis* rule be applied to the capital gain itself, not to the amount of investment held. I think it would be administratively simpler for taxpayers to handle

The second reason for arguing for a de minimis rule is that of simple practicality. For small amounts, the administrative cost of collection is large relative to the sum collected and there is a much greater likelihood of administrative mistakes by inexperienced taxpayers

What administrative implications would there be from a capital gains tax?

Many: Existing tax structures (e.g. the FIF regime, the Financial Arrangement regime, existing land tax structures, etc.) should be replaced entirely. At the risk of repetition, confusion and complexity arise where different tax regimes intersect, so for major tax reform to have credibility, existing tax structures that act upon any investment asset subject to a CGT must be replaced.

Careful thought would also have to be given to how the investment industry would have to adapt to accommodate new reporting and to replace existing systems for the reasons given above. This may represent a considerable cost to the funds management industry, all of which will eventually be passed on to savers.

One final thought. Any transition to a CGT must be much better-planned than the introduction of the FIF and PIE rules a decade ago. Both were rushed through Parliament with too little planning and caught the fund management industry unawares. The original FIF rules were far from clear and required numerous clarifications from the IRD over the years. It is my guess that if FIF tax returns from its early years were critically examined today, they would turn out to be riddled with errors –simply because the rules were so unclear and tax practitioners did not have time to get up to speed. As far as I recall, the introduction of the entire PIE regime had to be delayed by 6 months or so, simply because the industry could not set up the IT infrastructure to operate it in time.

This is not how Government should work. Particularly not one that places such an emphasis on "fairness"

There is another implication arising from the introduction of a CGT – it would also require a re-think of the provisional tax regime. Payment of the correct provisional tax requires taxable income to be relatively predictable from year to year – this is the basic assumption built into the "uplift method". However, capital gains are completely unpredictable from year to year, so the existing "uplift method" and "safe harbour" provisions may be quite unsuitable for a CGT regime.

What rules should govern the transition into a capital gains tax? The options seem to be cost of the assets (retrospective taxation of past accrued gains), valuation at date of introduction or only assets acquired post introduction (the Australian rule).

I have made the point above that there should be no retrospective taxation of past accrued gains. This would fly in the face of the Tax Working Group's objective "to provide as much certainty to taxpayers as possible as to what tax is due". Any notion of "fairness" rules out using the historical cost of the assets as the base point for a CGT.

Using the valuation at the date of introduction would cause another set of difficulties. For assets that are publicly-listed (e.g., listed shares) this is not a major problem, but for unlisted assets, it is. All of these would presumably have to be independently valued. The cost of all this would of course, be picked up by investors. Yet another burden for the "Jill Savers" of this world to bear. This approach cannot be described as "fair".

So this leaves the Australian Rule – assets acquired post-introduction - as the only "fair" way to transition into a new system.

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