Tax Working Group
Te Awheawhe Tāke

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LINK | Future of Tax – Written Submission

Tax Working Group| April 2018

The authority on selling businesses

Company Details

Name: **Link International Group Limited**

Company No: **1195509**

Document Approval: **LINK executive team**

Document Author: **Suneil Connor – CFO**

Email: [1]

The authority on selling businesses

About Us

Established in Auckland, New Zealand, LINK is the largest business brokerage in the world with over 2,500 listed businesses for sale at any one time. LINK has sold over 600 businesses in the last year with a combined value of over $300 million.

This submission focuses on current tax business in NZ face, and the issue of Capital Gains Tax (CGT) on sales of businesses.

Private Business (company) Contribution to the NZ Tax System and Lack of Subsidies

Income Tax

The *Future of Tax – Submissions Background Paper* noted on p28 that, in the year 30 June 2017, the Government collected $12.6 billion in company tax which, when compared to GDP, was the highest in the OECD. The paper goes on to note that the NZ corporate tax rate at 28% is the tenth highest rate of the 35 OECD countries.

GST, PAYE & Other Employer Taxes

Although PAYE is an employee tax, it is a requirement of the employer, most likely a company, to deduct PAYE on behalf of the Government, and pay this on behalf of the employee.

GST is a tax that is charged by the Government on all goods and services. The Government requires companies to hold the tax taken from GST and pay this to the Government on behalf of the consumer.

Both of the above taxes are a significant cost to the business in both administration, and opportunity cost of this time and expense. It can be argued that the Government has legislated the outsourcing of the collection of GST, PAYE and other employer taxes, to the private sector without any subsidy for providing this service.

Lack of Subsidies

Given the level of administrative burden and income tax level NZ companies are imposed with, there is a gaping hole in the subsidies the Government provides to businesses in NZ to assist with the cost.

Although a lack of subsidies exist for the administrative tasks performed by the private sector for the Government, there are subsidies for other priorities for Government such as Research and Development (R&D) expenditure. The current Government still noting the rhetoric that NZ is underspending in R&D, and it is a top priority to move NZ R&D spend up from current levels of 1.28% of GDP to the OECD average of 2.35%, has now slashed the subsidy available to NZ businesses. The existing and soon to be phased out R&D subsidy was 20% of eligible R&D spend paid out quarterly in cash to the business, will now be moving to 12.5% of eligible R&D spend to be added as a tax credit at the end of each year. Given the number of start-up companies who do not make a profit, notwithstanding 7.5% decrease from 20% down to 12.5%, the ability to use the 12.5% is dampened significantly due to lack of profits from companies, mainly technology exporters, who would increase NZ GDP when they become profitable. We would not be surprised to see R&D spend as a percentage of GDP drop significantly on the proposed changes, and although in speeches, representatives of this Government state moving R&D spend to OECD levels is a top priority, it is our view the Government is directly discouraging businesses to spend on R&D when compared to the previous rules, taking away what little cash subsidy a business in NZ received from their Government in the past.

Review of Reasoning For a CGT

Below are the two major issues that could be combated by a CGT outlined in *Future of Tax – Submissions Background Paper.*

Housing Affordability

The Reserve Bank Governor, Adrian Orr, recently commented on TVNZ's Q&A "when you see 90% of household wealth being equity in a home and 80% of the loans in banks are to housing and you see relative prices of housing where they are, then you're saying 'hey this is a real issue'".

The above statement from the Governer shows NZ has an overwhelming affinity with housing and given the ability to leverage $1 to $5 to purchase these assets without needing to pay tax on profits (excluding the bright-line test and traders), it makes sense that a lot of money has moved into this asset pool which has inflated prices.

The Government will bring in laws to extend the bright-line test to five years and establish rules to ringfence rental losses. The extension of the bright-line test is a CGT, and therefore, in our opinion, bringing in a comprehensive CGT would do little more to housing affordability than the adjustment of the bright-line from 2 to 5 years would do.

Disproportionate Ownership of Capital Assets

Within the *Future of Tax – Submissions Background Paper*, it was noted on p48 that capital assets are owned by higher income households and so introducing a capital gains tax would make the tax system more progressive.

The purchasing of capital assets such as land or shares is often with taxed income that is already subject to a progressive tax system. To state that introducing a CGT to make the tax system more progressive is using the wrong "p" word. The correct word would be 'punitive'. In a report by Statistics NZ in December 2017, it stated as at March 2017 household net disposable income was $148.0 billion, and household consumption was $152.1 billion showing a deficit of $4.1 billion. The statistics show us that New Zealanders are failing to save, and this may have long term impacts on retirement dependency.

To encourage saving, Kiwi's need an incentive to place their disposable income into assets that will appreciate long term. The incentive should be no taxes on the appreciation of certain asset classes.

CGT on Business Sales

New Zealand Small Enterprises

According to the 2016 Small Business Factsheet, small enterprises (<20 employees) make up 97% of all enterprises. Small businesses are the lifeblood of NZ, and the Government should be doing more to encourage business ownership.

CGT on Business Sales

Ageing demographic & lock-in effect

It is our view that imposing a CGT on business sales would directly discourage the needed and overdue divestment of businesses that are currently sitting in an aged demographic. In their *Success through succession planning* report, Xero identified more than 90,000 businesses are owned by people aged 55 and over. Imposing CGT on the sales of these businesses would encourage the owners to hold onto the business for as long as they can (lock-in effect), likely to the detriment of the business. We believe CGT would be at the forefront of the decision whether or not to sell the business as opposed to the factors business owners should be citing such as:

- What is the ideal market timing to sell the business?
- Who should I be selling the business to?
- Who can take this business to the next level to increase profits and employ more people?
- When and how would I like to retire?

Family owned house vs family owned business

The majority of small businesses in NZ are family owned. If a CGT were to be implemented, there would be an exemption for the family home. Given the exemption for the family home is due to it being a personal asset for family benefit, logic would suggest the same should apply to the family business.

Valuing different items within a business sale

Business sales are made up of property plant & equipment (PPE), stock, and goodwill, which is sometimes split into business and site goodwill. A CGT may motivate sellers to value different items to either derive a capital loss or a reduction in capital gain.

Increase in value due to profits which have already been taxed

We find the most common reason a business' value has increased over time is not due to economic cycles or that business value "always goes up" like the housing market, but because of the increased profit the business generates over time. This means the return on initial investment of the business is greater, which in-turn increases the value of the business. Hard work, sweat equity, risk-taking and entrepreneurial ambition increase profits. Profits which the Government has already taxed.

Stifling of entrepreneurial ambition

Businesses succeed because of entrepreneurial ambition, risk taking and persistence. One of the pay-offs for the risk undertaken is the increase in value of the business. A CGT may stifle entrepreneurial ambition and have flow on effects to employment, GDP and investment. Harvard Business School Professors, Gompers and Lerner, found that a one percentage point increase in the rate of CGT was associated with a 3.8 percent reduction in venture capital funding.

Investment into non-productive assets

We see many purchasers decide to buy a business given it is a productive asset that helps the economy, produces jobs and assists customer's needs. The alternative for a number of potential purchasers is to obtain a job from the market, and invest their earnings in owning a larger personal home which is a non-productive use of funds. A CGT may swing the decision back to investment in non-productive assets.

Positive economic impact

Within a Forbes article titled *The Overwhelming Case Against Capital Gains Taxation* (Forbes, 2014), Peter Kugler and Carlos Lenz (2001) examined the experience of regional governments ("cantons") in Switzerland that eliminated their capital gains taxes. The authors statistical analysis showed that the elimination of capital gains taxes had a positive and economically significant effect on the long-term level of real income in seven of the eight cantons studied. Specifically, the increase in the long-term level ranged between 1.1% and 3.0%, meaning the size of the economy was 1% - 3% larger due to the elimination of capital gains taxes.

Conclusion

There are a number of studies that state a CGT is damaging to the economy and well-being of a nation. We feel the current reasoning for a CGT is to move investment away from housing. The bright-line move to five years and ring-fencing of rental losses tackles this issue. If the Government were to introduce a comprehensive CGT, it would be a calculated strike at those who decide to save and invest their money in productive assets, and an attack on all small business owners in New Zealand.