Tax Working Group Public Submissions Information Release

Release Document

February 2019

taxworkingroup.govt.nz/key-documents

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;

[2] 9(2)(k) - to prevent the disclosure of official information for improper gain or improper advantage.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

No backdoor inheritance tax, please: submission on the tax working group's (TWG) interim report.

From Dr Murray Horn CNZM **15 October 2018**

<u>A CGT will end up adding relatively little revenue and lots of cost and complexity</u>

The interim report is starting to highlight just how much arbitrariness, complexity and cost is involved in introducing a comprehensive capital gains tax (CGT) and why countries that have one have tended to erode the CGT base over time as they try and deal with some its inherent problems.

A tax system should aim to raise the required revenue while minimising the associated economic, administrative and compliance costs. Distributive issues are better managed through targeted welfare and social spending.

Introducing a CGT in NZ is likely to involve more additional compliance and administrative cost than in most other countries because a much larger number of taxpayers who are not required to file a return pre-CGT, would have to do so if a CGT was introduced. Transition costs are also likely to be exaggerated by the suggested timing of introduction.[1]

It is not surprising that the two recent independent NZ tax reviews[2] both recommended against introducing a CGT that excluded the family home. Instead they recommended we should **continue with the current practice** of including particular capital gains in the income tax base as and when issues arise. There is nothing in the current review that justifies a different conclusion.

<u>However, if the TWG decides to recommend introducing a comprehensive capital gains tax, then</u>:

- **The base value of assets subject to a CGT should be uplifted to current market value at time of death, so there is no capital gain at death and successors only pay CGT on any subsequent gain**. Absent this value uplift, the CGT would act as an inheritance tax and that is explicitly ruled outside the scope of the TWG's review by its Terms of Reference (an inheritance tax is a tax levied on money or property acquired by inheritance or a tax on the estate of the deceased).

- **Death should not be treated as a realisation event.** If a CGT is not to become a backdoor inheritance tax, then "uplift" should occur at death and no gain recognised for CGT purposes (as above). While allowing roll-over at death imposes an inheritance tax on the gain in value of inherited assets, it also allows payment of this inheritance tax to be deferred. While still outside the TWGs Terms of Reference, this deferral would be better than not allowing either value uplift or roll-over on death. Moreover, as noted in the interim report, death does not involve the receipt of any consideration by the deceased and so fails the core definition of a realisation event. The arguments for taxing on death are also weak.[3]

[1] The Finance Minister is quoted on Stuff.co as saying "We will undertake the work and we will take it through to legislation. But no outcomes from the TWG will come into force until the 2021 tax year: i.e., 1 April 2021." The last date for an election is November 2020 and, given the likely controversy around a CGT, it is hard to see taxpayers (or even IRD) making the necessary investments to be ready for a CGT until after the results of the election are known. This timeframe is unlikely to allow for a smooth transition.
[2] The 2001 (McLeod) and 2010 (VUW) reviews of the NZ tax system.
[3] Basically to discourage lock-in (something that, if a serious concern, should discourage the introduction of a CGT in the first place) and raising more revenue (and if this is an issue then the current tax base is a better place to look to raise revenue without significant additional compliance and administrative costs).

- If the tax is to be levied at the taxpayer's income tax rate, rather than at a lower rate of say 15%, then **a 50% discount should be applied** as I understand is the case in Australia and Canada (i.e., in countries that also levy the tax at the taxpayer's income tax rate). This also provides a relatively simple way of adjusting for inflation, without incurring the lock-in or adverse selection problems of applying the discount after a fixed asset holding period.

- The only fair and accurate way to establish an opening capital value for assets to be taxed, at least illiquid assets, is **to only apply a CGT on assets acquired on or after the passage of the CGT legislation** (being the approach that Australia adopted when it introduced a CGT). Rateable values are not good enough for this purpose.[4]

<u>However, if the TWG decides to recommend against value uplift on death an in favour of applying selective roll-over relief on death, then</u> **roll-over relief should apply**:

- **to assets left to both the partner and the children of the deceased** on the basis that it is hard to distinguish between the former and the latter on the basis of an "… in substance economic unit in terms of their ownership and enjoyment of their assets and income from those assets." (p.145) This is also consistent with the approach to ownership changes on page 144 including that "Under tikanga concepts property can be often seen as being held for others, including future generations, and these interests should be accommodated by the tax rules." Family Trusts set up to hold assets for future generations should be treated on the same basis and so also "be accommodated by the tax rules".

- **to property that is illiquid**, including farms, because, as the interim report notes, it is undesirable that the imposition of the tax would result in a forced sale to fund the tax liability. Even land that could be sold, or a mortgage raised against it, should be excluded when this would effectively force a sale to pay for the tax. It is unfair for the government to take advantage of a realisation event it has forced to occur and then charge tax on the gain. This principle is acknowledged in applying roll-over relief to compulsory acquisitions and a common sense view of fairness suggests that this principle should be applied broadly.

<u>In considering the position of Trusts, then:</u>

- **If an inheritance tax is to be avoided by allowing a value uplift on death, then this value uplift should also apply to Trust assets when the settlor dies: i.e., beneficiaries (or the Trust) should only pay CGT on any capital gains made subsequent to the settlor's death**.

- **There should be no deemed realisation events for trust assets** because no consideration has been received at that time and no change of ownership has occurred. Forcing tax to be paid when there is no cash flow available from a sale could well force a sale, which the TWG seems to recognise as being both undesirable and unfair. Moreover, Trusts pay the highest

[4] Rateable values are only an estimate of the value that a willing buyer and seller would strike (an estimate that is likely to contain more error in rural areas where "like" transactions are less frequent). The valuation error implicit in rateable value does not matter a great deal when valuations are only used to assess the share of rates that are paid by different landowners. They matter a great deal more when valuations are used to establish a taxable base.

rate of tax on each taxable dollar, which, if the Trust tax rate is used for assessing CGT, significantly offsets the benefits of any delay in paying a CGT by having assets in a trust.[5]

However, if the TWG decides there is a need to impose a deemed realisation event on trust assets, then:

- **Deemed realisation should only apply to those trust assets not otherwise eligible for value uplift or roll-over relief on death, and only on assets transferred to a trust after a capital gains tax is introduced**, because the only argument for imposing deemed realisation on trust assets is that it prevents avoidance of CGT on death (i.e., asset transfers to trusts to avoid tax on gain on death). Clearly assets already held in trust were not transferred to avoid a CGT because no CGT existed when the assets were transferred.

If setting a deeming date for Trust assets ineligible for value uplift or roll-over relief, then:

- The interim report notes that **deeming realisation when the settlor dies** "… would be most consistent with the rationale behind denying roll-over relief on death… ".

- When there is more than one settlor, **roll-over relief should apply until the last settlor dies** (after which capital gains are only taxed again when the trust expires). The alternative of trying to identify which current assets were contributed by which settlor would require an arbitrary set of rules (e.g., when the original assets were no longer held in their original form or when assets were contributed jointly by a husband and wife (who are deemed as an economic unit for other purposes (p. 145))). Roll-over relief should also apply if the asset is transferred to a tax resident beneficiary of the Trust prior to the deeming date.

- **Roll-over relief should be granted when the trust would otherwise be forced to sell illiquid or indivisible assets** in order to pay the tax for the same reasons as outlined above.

However, if the TWG decides that a Canadian type of fixed "deeming date" should be considered then:

- We should also allow **roll-over relief if the asset is transferred to a tax resident beneficiary** of the Trust prior to the end of the fixed period, as the Canadians do.
- If the fixed period is supposed to represent "a generation", rather than just an arbitrary date, then the average age of a mothers giving birth to their first child in New Zealand was about 28 years in 2011, so **the date should be no shorter than 28 years after the introduction of a CGT**.
- **Roll-over relief should be granted when the trust would otherwise be forced to sell illiquid or indivisible assets** in order to pay the tax for the same reasons as outlined above.

- Given the great variation in the circumstances applying to different trusts, the **Trustees should be able to make an election** (at any time either prior to a fixed deeming date or immediately following the death of the first living settlor) if the deeming date should be when the last settlor dies or after a fixed period.

---

[5] For example, at a post-tax interest rate of 3%, the cost to a trust of the higher average rate of tax (33%) offsets the benefit of any delayed payment for about 27 years compared to most personal taxpayers (the highest average tax rate of those with taxable income under $48,000 is 15.4%).