Tax Working Group
Te Awheawhe Tāke

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.

Report to Tax Working Group – Future of Tax: Interim Report

Author: Craig Hastie, B.Sc., B.Com, CA.
Firm: Hastie Chartered Accountants Limited
[1]

Summary

In this report I analyse the Future of Tax: Interim Report (the "report") from the Tax Working Group (TWG).

I start by considering the rationale of the TWG in reaching its interim conclusions and attempt to show that many of their recommendations are based on opinion not verifiable fact. This then leads to a more detailed analysis of the recommendation for a Capital Gains Tax (CGT) based on a realised basis. I conclude by making a recommendation against a CGT on a realised basis and that further analysis of other options for review of the Income Tax Act are warranted.

Analysis

I have read the Future of Tax Interim Report with considerable interest. However, I was very disappointed that the interim recommendations reached in the report are, in my opinion, not supported by the facts presented in the report but, rather, are based on opinions that at first glance appear to be presented as facts. It seems to me that the TWG was determined before it started to recommend a CGT based upon asset realisation and then sought to make the "facts" fit its case. I will seek to show in my report the weaknesses in your report and why I have reached this conclusion.

Fairness

In your report you repeatedly state that the tax system must be "fair". However, you provide no definition of "fair" or "fairness". Fair to whom? The meaning of this word is very subjective – two different people may well have two completely different meanings as it depends entirely upon perspective. I for one simply have no idea what you mean by "fair" and "fairness" in the context of your report. In order for the word "fair" to have meaning in the context of your report, in my opinion, you need to provide a definition of this word and the term "fairness". So I ask that you provide a definition. Without such a definition it is, in my opinion, impossible for a reader to determine if your report meets its goal of recommending a fairer tax system.

As an example of what one person might consider fair and another unfair consider the question of a progressive income tax rate. Is it fair that the first dollar of taxable income is taxed at 10.5% whereas the 70,001st dollar is taxed at 33%? One may have worked just as hard for the first dollar as for the \$70,001st dollar. Whether this is fair or not depends upon what is meant by the word "fair" in this context.

Fact versus Opinion

Throughout your report you present opinion as if it is fact. A well written report that can withstand robust criticism will always differentiate between what is a verifiable fact and what is merely the authors opinion.

The problem with your approach is that an uninformed reader assumes that your opinions are supported by verifiable facts. In my opinion by treating the user in this way it merely weakens your arguments in favour of any particular conclusion and recommendation.

To illustrate what I mean I set out below a critical analysis of the section of your report "Part 1 Purposes and frameworks" page11.

- Point 3 – you state "If the ultimate purpose of public policy is to improve wellbeing then few areas of public policy contribute as much to the wellbeing of New Zealanders as the tax system". I question this. Is it the ultimate purpose of public policy to improve wellbeing? When did that become the law? For example, consider the public policy of sending troops to Afghanistan, it can certainly be argued that it did not improve the wellbeing of those troops killed there! Further you state that "few areas ….. as the tax system" but provide no evidence whatsoever to back up this assertion. So one can only conclude that this is merely the authors unsubstantiated opinion and one could say with equal validity "that few areas of public policy contribute as *poorly* to the wellbeing of New Zealanders as the tax system."
- Last sentence first column, "The tax system …. for the collective good of society". Does it? You provide no evidence to support this assertion. Therefore, one can only conclude that this is nothing more than the authors opinion. One could equally well assert that the tax system does no such thing. What is the "collective good"? This is nothing more than a vague and meaningless concept that means different things to different people.
- Last sentence first paragraph column 2, "… reducing inequality". Inequality of what? One can only assume that you mean the difference between the wealth of individuals. However, you provide no rationale as to why this is a good or desirable outcome. Reducing inequality may be important to some people and/or lead to a better society (whatever that means) but the view is entirely subjective. In my opinion for your assertion to have any meaning you need to provide a definition of what you mean by inequality, provide an explanation as to why this should be reduced and why this is a desirable outcome. Again you have presented an opinion as if it is an incontestable fact.
- Second paragraph "A policy instrument to influence behaviours". This paragraph strongly implies that tax policy can influence behaviour yet you provide no evidence to support this. Without some evidence how can a reader verify this? In my opinion a well written paper would provide some evidence and examples to back up such an assertion, otherwise again such an assertion is no more than an unsupported opinion.
- Point 5, page 11 – the report states that the TWG has taken a "rounded view" on the purpose of the tax system. What do you mean? Do you mean that the TWG has tried to "be everything to everyone", whatever that may mean?

Throughout the report you use phrases such as "many New Zealanders believe …." but never provide any idea what you mean by this (in this example, how many? 10? 100? 1,000? More than half of all New Zealanders?) or any evidence to back such an assertion. If such an assertion is to be made that can stand critical analysis then you need to provide a credible survey that arrived at such a conclusion. Without this such an assertion, in my opinion, has no credibilty. In my opinion one equally justifiably say "many New Zealanders do not believe ,,,,." and such a statement would be equally as valid (or invalid!).

I could go on but my report would run for over 100 pages as the report is filled with numerous such examples. The problem, in my opinion, with such an approach as yours is that one cannot rely upon the conclusions reached by you as they are substantially based on unsupported opinion not verifiable facts/data and are, therefore, in my opinion a very poor basis for determining policy.

Risk Free Rate of Return Method (RFRRM)

In your report you briefly mention the RFRRM of calculating tax for the purposes of a CGT. I was most intrigued by this method. However, I was disappointed that you only considered it briefly and provided no in depth analysis before dismissing it. Whilst not necessarily agreeing with it I would like to see the RFRRM receive full analysis for the following reasons –

- It is, based on your report, a relatively simple annual calculation.
- There should be few disputes over its calculation, thereby leading to few disputes.
- It would provide certainty to taxpayers.

CGT Based Upon Realised Gains

It seems to me that the main thrust of the report was to seek to recommend a CGT calculated on a realised basis. The report recommends that the tax would apply to real property, intangible property such as business goodwill and shares.

In the report you suggest that the CGT would only apply to the difference between the sale price and the cost if acquired on or after the implementation date or the value of the asset on the date of implementation. Thus requiring all assets subject to the CGT owned on the date of implementation but purchased before this date to be valued at their open market value (OMV). In my opinion –

- Valuation is a complex task in all cases.
- You suggest that for real property the rateable value could be used as a proxy for OMV. However, rateable value is precisely that – a valuation for rating purposes and is not specifically a market price. Furthermore, rateable values are only undertaken every 3 years, thus some values could be significantly out of date as at implementation date of the CGT. In my opinion, a well constructed CGT would allow the property owner to obtain a valuation from a registered valuer and adopt that rather than the rateable value. The cost of an independent valuation, in my experience, starts at $1,000 and goes up from there depending the property. Thus there is a significant cost.
- Obtaining an OMV for listed shares is simple.
- Obtaining an OMV for non-listed shares it can be a very complex and expensive exercise as it necessitates a valuation of the underlying assets and business of the company. One of the major problems is finding data on the sale of shares of comparable companies, for private companies this data is often not available. My experience shows that in some cases it is not possible to obtain an OMV for non-listed shares. If a valuation is obtainable the cost typically starts at $5,000 and goes up from there depending upon complexity. Based on your report ALL shares (including in private companies) will require to be valued as at implementation date.
- Obtaining OMV's for business goodwill is also a very complex and specialised task. This is a separate and different task to valuing shares, for a start not all businesses are owned by companies, many businesses are owned by sole traders, partnerships and trusts. If all businesses are to be included in the CGT then they will all require to be valued. This will include everything from the one man lawn mowing business to the largest multi-national. The cost per business will be significant, in my experience the cost will start at $1,000 for the simplest and go up from there. As a quick calculation if there are 100,000 businesses in NZ and the average cost is $5,000 per valuation the cost will be $500,000,000 (however I suspect that there are more like 500,000 businesses in NZ so the cost would be $2.5b). The cost for a multi-national or large business could, I suspect, be in the millions.

- In my experience many shareholders and businesses "struggle to make ends meet". So the imposition of a valuation will be a significant cash flow problem for them. I wonder if you have seriously considered the cost.
- Will there be enough valuers to undertake all the necessary valuations? The valuations will require specialists as the valuations will need to be able to stand Court scrutiny. Most accountants for example are not qualified to provide the types of valuations required. The more complex the business the more specialised and, hence, expensive, the valuers. Hence I suggest that there will be insufficient valuers for the task.
- If a taxpayer obtains more than one valuation or there is a dispute between the taxapayer and the IRD which value will be the correct value? Remember that a valuation is merely an opinion not an undisputable fact.
- Will the cost of valuation be a deductible expense against ordinary income in the year in which the valuation is obtained or will it only be deductible against a future capital gain? You need to clarify this. Given the likely cost of the valuations this is likely to have a significant effect on taxable income.
- In the report you have glossed over the effect of inflation and suggest that inflation should be ignored. I do not agree. In my opinion a CGT should allow for an annual inflation increase that is untaxed.
- It seems to me, based upon discussion with accountants who have had experience in a CGT in other countries, that a CGT is very complex and time consuming and, therefore, costly tax to administer both in the private and public sector and that the benefits, both from a revenue and effect on capital values perspective, are nebulous at best.

Due to the immensity of the task of obtaining all the necessary valuations I suggest that the valuation task will be beyond the resources of New Zealand and the cost will very significant. Further I believe that the time to obtain all the necessary valuations will be years not months. This assumes that a valuation can be obtained in all cases.

You fail to adequately deal with the question of capital losses. You suggest that either –
- losses will be immediately deductible against non CGT income, or
- losses will be "ring fenced" and only able to be offset against other CGT profits from that or future years.

In my opinion this is unsatisfactory. You need to make a clear recommendation one way or the other in order to reduce uncertainty. In my opinion losses should be immediately deductible against other income if gains are to be immediately assessable.

<u>Other Assets Subject to a CGT</u>

In your report you consider bringing into the CGT net assets other than real property, goodwill and shares, for example art works, motor vehicles. However, you dismiss bringing these in for three reasons –
(1) They are of an inherently private consumption nature.
(2) They are difficult to value.
(3) They generally go down in value.

I submit that this is a very convenient argument and is incorrect. For example, art works are, generally, relatively easy to value as a ready market exists and they, generally, go up in value. In my opinion on a theoretical basis either all assets should be captured in a CGT or none. Just because it is difficult should not be an excuse.

Finally, you exclude some assets on the grounds that applying a CGT to them would be politically unacceptable. In my opinion the decision to include or exclude on political grounds is the role of politicians and is outside the remit of the TWG. It seems to me to be a weak argument, in the context of a serious paper, to exclude an asset category just because it is considered by the authors to be politically unacceptable to do so.

Housing Affordability

I note that your report states that a CGT will have little effect on house prices. I agree with this. However, one of the reasons stated by the current Government to have a CGT was to reduce house prices and therefore improve affordability. This is, therefore, against, imposing a CGT on real property.

Your report also states, and I also agree with this, that rents are likely to increase if a CGT is imposed. Again the current Government wants to reduce rents. So again a CGT is not effective in this area.

Both these are reasons not to impose a CGT on real property.

Other Areas of Tax Review

One of the stated aims of initiating the TWG was to look at the tax system as a whole and the "fairness" (whatever that means) of it. Your report seems to suggest that there should be a consistency of approach throughout the Income Tax Act so that, whatever the source of the income or expenditure, it was taxed equally. However, you fail to undertake any detailed analysis of the current Income Tax Act in this regard.

For example, expenses for an agricultural business are often treated completely differently than for other businesses. Examples include –

- stock valuation – farmers have their own valuation schemes such as the NAMV scheme whereas all other taxpayers have to use cost. This has given many farmers a very significant tax free gain over the years.
- Farm development expenditure – farmers can immediately deduct costs that other taxpayers have to capitalise and depreciate (e.g. fencing).
- Some income can be spread over a number of years at the taxpayers discretion (e.g. forestry sales, the Income Equalisation Deposit scheme).

I wonder if the extra taxation that you seem to want raise could be more effectively raised by a more consistent treatment of income and expenditure across all taxpayers. Certainly it seems to me that further study of this is warranted by the TWG.

Your study touched on the issue of ring fencing losses from rental activities. It seems to me to be inconsistent that losses from rental businesses are treated differently from losses from other businesses. In my opinion this warrants further study by you if consistency and, perhaps, fairness are important.

Conclusion

It seems to me that the TWG has been somewhat myopic in its approach to and has been fixated on a CGT on a realisation basis from before the outset of its study to the exclusion of other potential areas of income tax reform. In doing so, it seems to me that the potential to raise income tax from other areas of reform has been missed. In my opinion further study into this may show that more additional tax revenue could be raised from reform of the current Income Tax Act than from adding an entire new tax such as a CGT on a realisation basis.

It is my opinion that reform or an additional new tax should only be recommended based upon solid, conclusive evidence not based largely on unsubstantiated opinion.

Given the complexity and likely cost of both enacting and administrating a CGT on a realisation basis it is my opinion that such a tax should not be recommended. Rather further study of reform of the current Income Tax Act for better consistency is, in my opinion, warranted.

I would welcome feedback from the TWG and am available to discuss my report.

CAHastie

C. A. Hastie

1 November 2018