Tax Working Group
Te Awheawhe Tāke

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Submission on *Future of Tax Interim Report*

Making the extension to taxation of capital effective and practical

Taxing capital gains is equitable

It is equitable as well as efficient to equally tax all forms of income generated from capital – whether that is interest, rent or capital gains realised after a short or long time. This is clearly not the situation currently. Take the example of two rental properties of identical value purchased with the help of a mortgage – one has high rent so generates a good annual cash return but gets little capital appreciation, and the other has low rent so barely breaks even after expenses but gets good capital growth. If they are both held for 10 years and then sold, the seller of the high rent property has paid considerably more in income tax than the seller of the low rent property who gets a big tax-free capital gain on sale. It could be that both investors have put in identical amounts of capital and earned identical amounts of cash, but one pays far more tax than the other – where is the equity in that?

Taxing capital gains on realisation causes problems and will raise little revenue initially

Capital gains are generally lumpy, being irregular and often large (like the sale of rental properties). Taxing these capital gains only when realised (when a sale occurs) causes a number of problems like discouraging sales of capital assets (lock-in) and giving an advantage from tax deferment. It also means there would be no significant revenue raised for some years from taxing all realised capital gains – assuming only gains accrued after the tax change is introduced are taxed (as qualifying assets are sold).

Delaying taxing capital gains until realisation makes the tax impost hugely uncertain

The delay caused by taxing capital gains only when realised also makes the amount of the tax hugely uncertain. A 'retirement nest egg' rental property could well be owned for 20 years before selling for example. Trying to look ahead over such a long period means it will be very uncertain how much tax, if any, will apply to the gain on sale. It is inevitable that several different governments of different political hues will come and go over such a time frame. The taxation of capital gains is a contentious issue so there is bound to be ongoing lobbying for various concessions and exemptions that will make their way into the regime.

The delay and uncertainly will severely blunt the effect of taxing gains on realisation

The delay and uncertainty that comes from taxing capital gains only on realisation means investors are highly likely to heavily discount their possible capital gains tax liability when thinking about the price they will pay for a capital asset they intend to hold for a while. People are generally not good at acting rationally when making decisions about the longer term anyway – which is why there are usually various incentives or compulsions for saving for retirement.

This inevitable discounting of the impact of the future taxation of capital gains may explain why capital gains taxes appear to have done little to lessen house price inflation in many countries around the world.

Taxing capital gains as they accrue creates a different set of problems

An alternative to taxing capital gains on realisation is to tax them as they accrue – like taxing annual increases in value. While this would mean investors would start paying tax on any capital gains almost straight away, this option brings a whole different set of problems. First there is the practical difficultly of fairly determining how much gain has accrued each year.

Secondly, there is the serious potential liquidity problem of taxing the accrued gain on an asset that has generated little or no cash. The accrued gain could in some years be huge compared to the 'cash return'.

Example A
An Auckland rental property of $1 million might rise in value by 15% in a good year so generating an accrued income of $150,000 compared to its net rental income of maybe $31,000! Even assuming there is no mortgage against the property, at tax rate of 33% that would leave a cash deficit of $39,270 or $755 a week!

Not surprisingly, the Tax Working Group (TWG) is not proposing to tax capital gains as they accrue.

A less problematic alternative is taxing deemed returns

A kind of compromise between taxing capital gains on realisation and taxing them on accrual is taxing deemed returns like the TWG is considering for certain classes of assets. If applied more generally, a deemed-return tax would take a capital asset like a rental property and assume the risk free rate of return is earned, maybe 2.5% of its value, and treat this as income earned regardless of actual expenses. An alternative could be to deem a higher rate of return, reasonable for the asset class, and allow expenses to be deducted.

There still has to be a valuation process but getting total precision with the value would not be as crucial as with taxing accrued gains (when the difference between the current value and value in the preceding year would be all important). The rating valuation system may generally give a sufficiently accurate value.

Taxing deemed returns would still create significant liquidity problems for some

Applying a deemed rate of return tax wouldn't produce the lumpy income that taxing accrued gains would. However, while taxing deemed returns would produce a reasonably consistent income figure, it could still impose significant liquidity problems. Rental properties, for example, often do not break even after expenses and interest. While some landlords are willing to have properties that make a loss for several years or more because

of the likely capital gains down the track, imposing a substantial tax impost each year in addition to having to cover the loss could hit them hard.

Example B

Applying the deemed rate of return approach to a $1 million Auckland rental we might use a risk-free rate of 2.5%. This gives a deemed income of $25,000 per year or $480 a week. A reasonable rent for such a property might be $700 a week with expenses of $100, leaving $600 a week profit and generating a return of 3.1% so the deemed income approach leaves the landlord better off, at least in a year with low property expenses.

Example C

If the $1 million rental is purchased with a mortgage for 60% of the price, an interest rate of 5% and term of 20 years, this gives a weekly repayment amount of $911 – a shortfall of $311 a week but if it is changed to an interest-only mortgage the cost is reduced to $577 a week which allows the rental to just break even. There is virtually no surplus cash to pay tax on the $480 a week of deemed income – which with a marginal tax rate of 33% generates a tax liability of $190 a week or $8,250 for the year.

A better alternative would be a 'minimum provisional capital income'

A more pragmatic proposal for extending the taxation of capital with less likelihood of causing a significant liquidity squeeze would be to deem a 'minimum provisional capital income' (MPCI) to be earned from qualifying assets. The rate for calculating the MPCI could be set at a very low percentage like 0.5% of the value of the capital asset. It would mean at least a minimal amount of regular income is attributed to qualifying capital assets, with an eventual 'wash up' on the realisation of those assets. The MPCI works like an advance payment of capital gains tax.

Since a MPCI would apply from day one, investors would take notice but at the same time the low amount of minimum income imposed means it should not be an undue burden. Because it is a minimum, it also wouldn't apply if the asset was actually producing taxable income greater than the MPCI.

Example D

If the MPCI calculation rate is 0.5% then our $1 million Auckland rental property generates a minimum provisional capital income of $5,000 or $96 a week, which at a marginal tax rate of 33% gives a tax liability of $1650 or $32 a week compared to negligible taxable income and tax for income tax purposes when there is a $600,000 5% mortgage.

Example E

If the mortgage on the rental is $200.000 then the interest cost is $192 a week, leaving a surplus for tax purposes of about $400 a week or $20,000 a year. The MPCI does not apply in this case as the minimum income of $5,000 is surpassed.

Since the MPCI is provisional, there is a wash-up when the asset is sold and the exact gain (or loss) determined. Any incremental MPCI already returned (the difference between the income otherwise calculated for income tax purposes and the higher income of the MPCI) is allowed to be taken into account. This incremental MPCI goes into a capital income credit account (CICA) each year to be carried forward until the asset is sold.

Example F

To illustrate how the wash up works we go back to our $1 million Auckland rental with a $600,000 5% interest only mortgage generating no income for income tax purposes, so has the whole $5,000 of MPCI (on which tax is paid) going into the CICA each year. If this happens for 5 years in a row (for the sake of simplicity) and the property is then sold for a capital gain of $200,000, there is $25,000 in the CICA to credit against the realised gain so the taxable gain on wash-up is $175,000.

Example G

If market is flat market so there is no capital gain then the $25,000 in the CICA is used in the sale year to offset any other taxable income of the taxpayer. Any amount not able to be used is carried forward to use in following years.

MPCI calculation rate can be gradually increased and reduced if necessary

Because the MPCI is provisional, the rate applied to calculate it doesn't have to be set in reference to anything and can easily be varied from year to year. This allows a 'suck and see' approach with an initial very low calculation rate applied to see what happens to qualifying capital assets. The rate can be gradually ramped up over time so investors are not unduly shocked, and any falls in the price of assets it hits the hardest are limited. The rate can be reduced if necessary.

Dealing with intangible assets

The MPCI would apply only to intangible assets that can be easily valued so not business goodwill, for example, unless it was purchased goodwill.

Dealing with capital losses

The TWG acknowledge if capital gains on qualifying assets are always taxed then there is an equity argument for allowing the recognition of capital losses, but this has to be managed to discourage gaming. Capital losses at wash-up could be restricted to being gradually realised over say 5 years.

Example H

If we take the circumstances of Example F but there is a capital loss on sale of $10,000, the balance in the CICA of $25,000 is allowed as an immediate reduction in taxable income. A capital loss of $2,000 is also able to be used in that year with a further $2,000 loss able to be used in each of the following 4 years.

Submitted by Anthony Morris, 31 Oct 2018