Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

Release Document

February 2019

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SUBMISSION ON THE INTERIM REPORT OF THE TAX REVIEW GROUP

This submission focuses on the Group's interim recommendations relating to a possible capital gains tax.

Are 'Capital Gains' appropriately described as 'Capital Income'?

2 The rationale in the report seems to be that 'realised capital gains provide a basis for consumption in the same way as labour or interest income' (see paragraph 11 of Chapter 5 of the Group's Interim Report), hence why it equates 'capital gains' with 'capital income' and chooses throughout the report to refer to 'capital gains' as 'capital income', and therefore like all other forms of 'income' appropriately subject to tax - and at the same rate as other forms of 'income'.

3 Yet capital assets, whether in the form of property, shares, term deposits or other forms of investment, are generally seen as capital rather than consumption items which are set aside as savings to be retained for future requirements like retirement or assistance to family. They may also be accessed for major expenditure needs such as housing improvement or overseas travel but for most people they are viewed differently from funds in hand in the bank required for everyday living.

4 Where this distinction becomes relevant is that the taxation of capital and savings, separately and on top of income derived from these, may negatively impact on these through discouraging such investment and saving and encouraging greater consumption. Part of the concern is of course that too much capital at present gets directed toward residential property to the detriment of alternative investment in other more productive areas of the economy. But it is not clear how the changes proposed by the Working Group will, at least on their own, really address this issue since it is proposed to tax capital gains not only on non-residential property but also on shares (along with the existing tax on financial instruments). Furthermore, it is arguably not so much non-residential rental housing which is non-productive (after all, people need houses to live in if they do not own their own) so much as owner-occupied homes, at least where large sums are invested in these going beyond essential albeit good standard housing requirements (e.g. where a 'mansion effect' might occur - see paragraph 14 of Appendix B).

5 There seem to be good grounds for considering some level of taxation of capital gains (e.g. fairness, equity, to help address inequality) but care is needed to keep in mind that society needs to encourage saving, not least for retirement when individuals will no longer be able to rely on labour income and will be reliant on income from capital - as well as the actual capital itself. This applies as much today for the presently ageing population as it will for future generations as they too age.

6 The report does make the interesting point that such taxation may be a mechanism to help to contribute to inter-generational equity. In a situation where a reducing labour force will be being asked to support from taxation a growing ageing population, this is a fair point. But future generations will also need in turn to accumulate capital to help them in their retirement. Accordingly, an appropriate balancing of interests will need to be achieved.

7 If a capital gains tax is to be introduced, there may however be merit in calling it that, rather than treating it as another additional form of income tax, so that the qualitative difference between them is not lost.

The Form of a Possible Capital Gains Tax

8 The Tax Group's Interim Report chooses to focus on just two possible options, involving the taxation of gains on realisation or based on a risk-free rate of return. It would have been useful somewhere to learn about the range of forms which capital gains taxes have taken in other jurisdictions (including the Australian inclusion of a 50% discount where the asset has been held for more than 12 months and the Canadian approach of taxing 50% only of the gain) and the lessons which might be drawn from their respective merits or shortcomings so as to inform assessment of the two options flagged or lead to consideration of other possibilities.

9 Both options discussed by the Group involve the targeting of particular types of gain rather than a more broad-based approach. Thus, personal use assets are excluded which seems sensible for the reasons given in paragraphs 17 and 18 of Appendix B. In the case of higher value jewellery, fine art and other collectibles, these are not necessarily bought as investments and in any case their value can be both volatile (e.g. antiques), difficult to assess and often then hard to realise. This contributes to the likely high cost and complexity of their inclusion. Accordingly, their exclusion also seems reasonable.

10 Of the two options flagged, the taxation of gains on actual realisation seems the fairest and most appropriate and it seems from Appendix B that this is the Group's favoured option (see paragraph 23 of Appendix B). This seems an appropriate preference.

11 As the Group notes, the actual realisation approach has the advantage that the taxpayer has the funds released by the realisation of the value of the asset to draw on in meeting the tax due. There is also a clearly determined value on which the calculation of the tax is based. It is therefore relatively simple and fair.

12 It also seems appropriate that, if the property is sold at a loss, then the amount of such loss (against the purchase price) can be offset against other 'income' (or gains). The Group seems to contemplate however that such losses will only be able to be offset against gains from the sale of other like assets, not against a taxpayer's other sources of income (e.g. labour income, capital 'income such as interest, dividends, and rent). The problem with this is that, for many taxpayers, they may only own one or two non-residential rental properties or a small commercial/industrial property and perhaps as well a small quantity of shares. Accordingly, the facility to offset a loss against sales of other property or of shares may be quite limited. Ideally, therefore, they should be allowed to offset against other income,

especially if capital gains are to be treated as a form of 'income'. If the taxable gains (and losses) are being ring-fenced around gains or losses on the sale of the same class or classes of assets, then a generous period of time should be allowed over which they may be permitted to offset any loss or losses.

13 In the case of the alternative approach based on a risk-free rate of return, it is noted that this form of tax would replace the taxation of income from a property subject to this regime so that any income (e.g. rental) derived from the property, and any expenses associated with earning that income, would be ignored for tax purposes. The problem with the proposal is that we do not know at what level the 'risk-free rate of return' would be pitched. If the risk-free rate of return was based on the Government 2-year bond rate as suggested in paragraph 78 of the Report, and interest rates rise, this could see a substantial movement in the rate of tax being levied and it would not take into account the level of actual rental income received or the expenses incurred in deriving it. Nor is there any evidence that the Group has undertaken any empirical work to assess the sort of net returns which owners of properties which would be subject to this tax customarily derive such that there could be confidence that the level of the tax was reasonable and affordable. If it were pitched too high, it could have very serious impacts for owners as it may exceed their net 'income' from the property, ultimately forcing them to sell because of the absence of sufficient cash generated from the rental income, less expenses, to cover the liability.

14 Further, it would require an annual assessment of (net) market value which could be onerous, expensive and difficult. If a current rateable value were relied on for a property value, this might in certain market conditions overstate the market value of the property.

15 Other downsides are:

- it would seem potentially to encourage owners to take on higher levels of debt in order to reduce their equity (and thereby their tax exposure);
- it could discourage owners from making improvements to their properties since doing so would increase the taxable value of the property unless they borrowed money to fund the improvements;
- it may encourage owners to minimise maintenance and repair expenditure since such expenditure would cease to be a tax deductible expense; and
- any increase in costs (e.g. in getting regular updated valuations) might be passed on to tenants, contributing to rising rents, or cause owners of such properties to exit the market, benefiting new home-buyers but reducing properties available for rent, thereby also putting pressure on rent levels.

The Level and Nature of the New Tax

16 The Group has proposed that the gains to be taxed should be regarded as 'income' and therefore taxed at the marginal rate of the taxpayer in the year in which the gains are realised. There is a question flagged above as to whether these 'gains' should really be treated as 'income', even if it is decided that they should be taxed. For the Submitter's view is that these gains are different, for the reasons given above. This is evidenced by the fact that the gains are the product of the holding of an asset for a number of years, such that taxing them at a taxpayer's marginal rate of income tax in the year of realisation has a certain measure of artificiality and possible arbitrariness.

17 It might therefore make more sense to set a separate rate specifically applicable for the taxation of capital gains. Some countries seem to have done this. In the United Kingdom, the rate for gains on property seems to be 18% for those on their 'basic' income level (10% for other assets) and 28% for those on a 'higher income' (20% for other assets). Others like Denmark, Germany and the United States seem also to have rates set independently of the taxpayer's marginal rate of tax though differential rates may apply based on which sort of income tax bracket a taxpayer falls in.

18 It is submitted that an option worth consideration might be a flat rate equivalent say to GST (i.e. 15%) for payment on gains made from asset sales to be covered by the new regime. The logic of such an equivalence would be that some taxpayers opt to use their savings to spend or consume and pay GST on their purchases while those who save and then enjoy gains on the value of those savings might pay an equivalent amount. This might be a mechanism for avoiding the risk of disincentivising saving and investment through the levying of too burdensome a tax on gains made from investments. It might also pitch the new tax at a level which would attract wider acceptance. Having a fixed rate would also avoid the taxable gains in the tax year of realisation pushing most of the gains above a taxpayer's otherwise applicable marginal rate of tax which would likely be the case for any taxpayer on a marginal rate less than the maximum of 30%.

19 An alternative would be, as some others have done, to have two rates of tax on capital gains, pitched at different levels based either on the marginal rate of income tax of the taxpayer (as seen in the United Kingdom's two-tiered rates) or based on the nature of the gain (property, shares) being taxed (as seen also with the United Kingdom's differentiated rates for gains from property and shares respectively).

20 It appears that the Group would treat gains made on the sale of rural (farm) land in the same way as any other land (commercial, industrial, residential) to be subject to the new taxation regime. But real care is needed to avoid a situation where substantial damage might be done to the economics of our traditional forms of pastoral farming for which levels of annual income can for many be quite low and certainly very cyclical and for whom the capital gain acquired on retiring from the business has often been the means of supporting the retiring farmer in retirement. The proposed roll-over provision would seem relevant for farmers expanding their business to larger properties and perhaps also for those looking to transfer a farm on to a son or daughter. But the particular challenges for farming of a capital gains tax warrant careful consideration.

Transitional Rules

21 The Group favours having the new tax take effect for all covered properties (i.e. excluding family homes) on the date of entry into force. They do not favour following the Australian approach of having the new law apply only to properties as they are acquired after the entry into force of the new law. The Group acknowledges the advantage in the Australian approach of removing extensive valuations when the law comes into effect but is concerned that taxpayers may be encouraged to sit on existing properties of the type that would otherwise be taxed so as to accrue the capital gain without the tax.

22 However, an important consideration (see paragraph 13 of Chapter 2 of the Interim Report) is that taxation should be predictable and certain. The move to a system involving the imposition of a more broadly-based capital gains tax is a major change for taxpayers. Taxpayers to this point have ordered their affairs on the basis that there is no broad-based capital gains tax on property and shares. And, where a new tax on capital gains has been introduced (as for the two bright-line tax changes), these changes have been implemented prospectively for new transactions/purchases occurring after the date of entry into force. It would be appropriate here too to follow the same approach so that taxpayers who have made decisions on the basis that there is no such tax do not now suddenly find that the basis on which they acquired the property in question has materially changed.

23 While this would entail a longer transition, it would also enable a more orderly and fairer one and one in which the change might be better understood and accepted. The alternative of having to have all existing property subject to the new tax specially valued will prove extremely burdensome and probably costly for taxpayers affected. In the case of property, rateable values are not likely to be a satisfactory proxy as they can be at quite significant variance to the actual market. There is also a particular difficulty if values at the time of entry into force are actually lower than the original purchase price of the asset, plus in the case of property the cost of any improvements since. Accordingly, there might need to be an option to take a higher assessed 'value' than the market value at the time of valuation based on actual cost at the time of purchase (plus, in the case of property, the actual cost of any improvements).

24 If the length of time before the tax takes effect in this scenario for currently held property and shares is still a concern, it might be possible to allow for a transition of say 5-10 years for holders of existing shares and covered property such that, for existing owners of such assets, the legislation would kick in in 5-10 years time at which point any taxpayers still owning such assets would need to secure valuations effective on that date. This would avoid a long tail of say 30 years as mentioned in the Group's report. A solution would still need to be identified for assets which at the point of valuation have a lower market value than the original cost (plus any improvements).

25 The Group observes (paragraph 31 of Chapter 6 of the Interim Report) that, if taxation is extended to capital gains on the sale of land (excluding the family home), some existing provisions imposing tax on the gains made on some sales might need to be amended or repealed. Clearly this will be affected by the nature of the transitional arrangements but presumably existing provisions (e.g. the bright-line test) would continue to apply for all land (other than family homes) not yet subject to the

new tax regime (e.g. if this regime applies only to new acquisitions made after entry into force of the new law).

The Encouragement of More Productive Investment

26 One of the consistent reasons given for the introduction of a capital gains tax is to encourage capital and investment into more productive sectors of the economy through providing a greater range of choice for individuals wanting to invest their savings. The extension of capital gains taxes not only to all categories of non-family homes and property but also to shares, supplementing the capital gains tax already in place for financial instruments (and certain property sales), will not immediately help since the present level playing field between property and shares would continue (aside from the continued exclusion of family homes from the tax) with both becoming subject, on the basis of the Group's current thinking, to the same level of capital gains tax. More fundamentally, it is not always clear how much the encouragement of increased investment into shares (or financial instruments) will necessarily help fund more productive investment since most share investment is simply acquiring shares already issued; it is seldom funding new share issues or new debt instruments to aid the expansion of businesses. Whilst outside the role of the Working Group, it is important that efforts be made to deepen the range of investment opportunities for tangibly supporting economic productivity and growth.

27 One idea mentioned by the Group (paragraph 14 of Appendix B) in relation to the family home, often argued to be one of the areas of least 'productive' investment, is to set an upper limit around the exemption to be allowed for the family home. This would seem an idea worth exploring since, if there is to be a capital gains tax on all other property, there is a risk that taxpayers may be encouraged to increase their investment in their family home not so much to accommodate their needs as a family so much as to increase the value of the property and thereby reap greater benefit from this proposed family home exemption.

Roll Over Provisions.

28 The proposed inclusion of these seems reasonable.

29 While not an issue of roll-over, drafters need to be careful to ensure that, when title to land or shares is changed to allow for a change of trustees in a Trust, this change of name is not unwittingly regarded as a sale or disposal. Such changes of trustee can be required because professional trustees in Trusts formed some years ago are now having to retire and are being replaced by incorporated companies whose lawyer directors become the replacement professional trustee. This form of replacement will avoid the need for future changes of professional trustee and the associated adjustments to property and mortgage titles and share registers. But, where any change of trustee does occur, with associated transfers of title from the old to the new trustees, the change does not alter the nature and identity of the tax entity which owns the asset and should not therefore give rise to any suggestion that a sale or disposition has occurred such that a capital gains tax on the transaction might become payable, whether on that transaction or on a future transaction based on the asset having through the replacement process kicked in the application of the new capital gains tax regime.

Gift Duty

30 Passing reference is made to gift duty and the Group does address issues around the taxation of Trusts and companies, identifying as the main tax-related issue being in relation to closely-held companies.

31 There has been commentary in the media indicating concern about the way in which some business people seem to have been able to shift assets to entities beyond the reach of creditors in circumstances which appear unjustifiably to prejudice unsecured creditors (e.g. sub-contractors). It is not clear whether these actions have been undertaken in a way which would contravene the business person's obligations toward their creditors in which case it may be possible to re-open the transactions and claw back the money affected. But is there any evidence that the abolition of gift duty has made it easier for business people to transfer funds out of a business through gifting to a separate entity in circumstances where such transfer is seen as unreasonable in terms of their duties to creditors?

Administrative Changes

32 It is suggested that it may be desirable to have some form of contemporaneous documentation to be filed with IRD on an annual basis, itemising the cost of assets subject to the new rules. Care should be taken about creating more and potentially quite onerous and detailed annual reporting obligations. Clearly taxpayers will, if changes are introduced to impose a capital gains tax on sales of certain property and all shares, have to keep records of all future purchases and improvements (if the law is applied only to future acquisitions). If it applies to all covered property and shares already held, but affecting only increases in value from the date of entry into force of the law to the date of sale, then documentation will be required to establish starting values. In this scenario, maybe taxpayers could be given a period of 1-2 years to document all affected property and shares with the relevant values at the time of entry into force duly recorded, with a reference to the basis for the valuation. As mentioned already, there may also need to be a process for valuation which allows for the situation where the original cost price (plus improvements in the case of property) actually exceeds the value of the property or shares at the time of entry into force.

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Date: 1 November 2018