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.

DLA Piper New Zealand
205 Queen Street
Auckland 1010
PO Box 160
Auckland 1140
New Zealand
DX CP24027 AKLD
T +64 9 303 2019
F +64 9 303 2311
W www.dlapiper.com

1 November 2018

Tax Working Group
By email submissions@taxworkinggroup.govt.nz

To whom it may concern

SUBMISSION ON THE TAX WORKING GROUP INTERIM REPORT

1 Thank you for inviting submissions on the Future of Tax: Interim Report (**Interim Report**).

2 Our comments on the Interim Report are summarised below:

2.1 If the TWG recommend a Capital Gains Tax (or an extension of income tax to capital gains) (**CGT**) then a broadly drafted roll-over relief will be critical where business assets are disposed of and the proceeds are reinvested (or partly reinvested) in replacement business assets within a reasonable period of time. This will be particularly important in the New Zealand context.

2.2 We support the TWG's recommended further tax changes to the treatment of KiwiSaver. However, we consider that the TWG's recommended changes to the taxation of KiwiSaver should be extended to all registered retirement schemes. If the TWG recommend a CGT, then assets in registered retirement schemes should be excluded.

2.3 We support the TWG's approach that it will not change the Portfolio Investment Entity (**PIE**) regime and that the single level of taxation at the PIE level should be maintained.

2.4 If the TWG recommend a CGT, it should also consider a CGT exemption for assets held within a PIE. If, however, the TWG recommends that CGT applies to assets within a PIE, we consider there should be an option to calculate that tax on a deemed risk free rate of capital return basis.

2.5 We support the suggestion to increase the $10,000 limit for the automatic deduction for legal fees for tax purposes.

Capital Gains Tax (CGT)

3 The introduction of a CGT (or an extension of income tax to capital gains) would have a significant impact on the structure of New Zealand's tax framework. New Zealand's current income tax framework (both legislative, judicial opinion and common understanding) has developed over many years on the basis that New Zealand does not tax capital gains. Companies, individuals and foreign investors have proceeded on that basis.

4 We would recommend that CGT is not introduced without sufficient time to consider all of the potential issues. In general, we consider the proposed timeframe for the introduction of CGT is too short.

CGT and roll-over relief for replacement business assets

5 The TWG Interim Report has indicated that, if CGT is recommended, then roll-over relief should also be allowed. However, the report states that the TWG is still considering the extent to which roll-over relief should be provided. In particular, the TWG has not confirmed whether roll-over relief would extend to situations where business assets are disposed of and the proceeds are reinvested. The Interim Report goes on to outline a number of disadvantages that could arise from this type of roll-over relief.

6 **We are concerned that the TWG would consider recommending CGT without a broadly drafted roll-over relief applying where business assets are disposed of and the proceeds are reinvested, particularly in the context of the New Zealand economy**.

7 New Zealand is a relatively small economy with a limited number of large companies and access to capital is constrained. The economy relies heavily on small businesses: for example shops, farms and agricultural businesses. Those businesses have tended to grow organically. Individuals, who are able to develop a small business into a larger business, will often look to sell that business and buy another one when they become constrained, for example, by the size of the shop, farm, or land available.

8 If CGT applies to these situations and there is no roll-over relief where the business sales proceeds are reinvested (or partly reinvested) in a replacement business, then it will create an impediment to the growth of these small businesses into medium sized (and ideally large) New Zealand businesses.

9 Further, roll-over relief would be important to protect business owners in the event of unexpected capital realisations. The TWG's report refers to intended transactions. However, the broad nature of CGT is that it can apply in a number of unexpected situations and potentially any value shift between individuals can trigger capital realisations. Examples include: forced sales; changes to partnership/joint venture agreements; separations; and court settlements. It seems inequitable that a business owner might have to pay a CGT in these situations, which would prevent them from being able to buy an equivalent sized business and continue trading.

10 The TWG report also refers to the equivalent relief in the US tax code[1]. However, it would seem that there are regimes in more comparable jurisdictions that should be considered.

11 The UK's business asset roll-over relief[2] provides a broad roll-over relief for businesses which acquire new assets within three years from (or up to one year before) selling or disposing of the old assets and also allows partial relief where, for example, a business reinvests part of the proceeds from selling the old assets, or where old assets were only partly used in a business. The UK approach would seem to be a more appropriate approach in the New Zealand context and we consider a reasonable timeframe for reinvestment would be one year before or three years after the relevant sale.

12 **In summary, we consider that for CGT to be workable in the New Zealand context a broad based roll-over relief will be necessary that applies to proceeds reinvested within a reasonable period of time.**

Retirement savings

13 Retirement savings is one of the most important areas being considered by the TWG and is critical for the future wellbeing of all New Zealanders. Any recommendations in the TWG's final report in relation to retirement savings must be comprehensive and consider all forms of retirement savings.

14 KiwiSaver has been successful in raising individual levels of retirement savings in New Zealand. We support the TWG's recommended further tax changes to the treatment of KiwiSaver, comprising:

14.1 the removal of the employer superannuation contribution tax (**ESCT**) on employer's matching contribution of 3% of salary for KiwiSaver for employees earning up to $48,000;

14.2 a 5% reduction of the lower PIE tax rates but only for KiwiSaver funds;

14.3 simplifying the way PIE rates are determined for KiwiSaver members; and

14.4 the suggestion that the member tax credit (**MTC**) could be increased to 1:1 basis.

15 However, the TWG's Interim Report suggests that KiwiSaver is the only way that New Zealanders are saving for retirement. Individual retirement savings in New Zealand are held

[1] US Internal Revenue Code, section 1031.
[2] Taxation of Chargeable Gains Act 1992, section 152.

in a wider range of registered retirement schemes[3]. Registered retirement schemes comprise:

15.1 KiwiSaver;

15.2 Superannuation Schemes, which lock in funds until retirement; and

15.3 Workplace Savings Schemes, which typically lock in funds until retirement or on leaving service from an employer.

16 Superannuation Schemes and Workplace Savings Schemes (excluding KiwiSaver) make up a significant proportion of New Zealand's total retirement savings, and at June 2018 held funds of in excess of NZD 24 billion (in comparison to KiwiSaver which holds funds of in excess of NZD 50 billion)[4]. These schemes offer certain advantages to individuals and employers, including enabling higher contribution rates by employers and other features such as life and disablement insurance. If the TWG's objective is to make the 'tax treatment of retirement savings scheme fairer'[5], the current and proposed tax treatment of KiwiSaver (and complying superannuation funds) should be extended to all registered retirement schemes.

17 We assume the intention is that the TWG's proposed tax changes to KiwiSaver would also apply to Complying Superannuation Funds as they comply with the KiwiSaver rules[6].

18 Finally, the TWG should consider and address the high rate of tax that applies to defined benefit workplace savings schemes, where there is no facility to apply anything other than the top 33% ESCT rate and (at best) the 28% widely held superannuation fund investment income tax rate even where most or indeed all members may have already retired and begun receiving a pension.

19 The taxation of lifetime annuities in New Zealand also needs to be considered, where investment income relating to the funds underpinning any such annuity are taxed at 28% and then the annuity itself may be subject to tax on distribution in some cases.

20 **We consider that the TWG's recommended changes to the taxation of KiwiSaver should be extended to all registered retirement schemes.**

CGT and retirement savings

21 We are also concerned that any form of CGT on registered retirement schemes (including KiwiSaver, Superannuation Schemes or Workplace Savings Schemes) could significantly

[3] Registered means those Superannuation Schemes, Workplace Savings Schemes and KiwiSaver Schemes as those schemes are defined in the Financial Markets Conduct Act 2013 and that are included on the register of managed investment schemes.
[4] https://www.rbnz.govt.nz/statistics
[5] Interim Report, page 6.
[6] We note that current tax benefits, including member tax credits, extend to KiwiSaver and certain Complying Superannuation Funds (refer definition of Superannuation Savings Scheme in s.YA 1 of the Income Tax Act 2007).

undermine the value of retirement savings in real terms, particularly as inflation already presents a risk to the real value of amounts held in retirement schemes.

22 In addition, the TWG will be aware that an introduction of a CGT to assets within the PIE regime (discussed below) will also be a form of tax on retirement schemes as most retirement schemes are PIEs.

23 **If the TWG recommend a CGT, then assets in registered retirement schemes should be excluded.**

Portfolio Investment Entity regime

24 The PIE regime is an important part of New Zealand's investment and retirement savings framework. The majority of New Zealand investment vehicles are now PIEs and we expect the PIE regime will become increasingly important, particularly with the introduction of the Asia Region Funds Passport which will enable New Zealand asset managers to more freely market New Zealand funds to non-resident investors in those jurisdictions covered by the passport. A key feature of the PIE regime is the single level of taxation at the PIE level (and no tax for foreign investment zero-rate PIEs), with no further tax at the investor level.

25 We support the TWG's approach that it has not proposed any changes to the PIE regime and that the single level of taxation at the PIE level should be maintained.

26 As noted in the Interim Report, at present, gains on New Zealand and Australian shares are not taxed, and gains on the sale of other foreign shares are generally not taxed and instead tax is calculated on a deemed rate of return (Fair Dividend Rate or **FDR**) method. In practice, for most PIEs, income is allocated to investors on a daily basis and tax is applied accordingly. This current tax treatment enables PIE calculations to be done for those investors who enter and exit PIE funds on a daily basis.

27 Unfortunately, the TWG's Interim Report does not provide any real detail as to how CGT would apply to assets held in a PIE. The difficulty with capital gains is that (unlike income) it will not be known whether an asset will generate a gain or loss until it is ultimately realised. A CGT in a fund can give rise to inequitable results for investors, because it will not be known if a particular asset will ultimately give rise to a gain or a loss until it is realised, but tax will need to be calculated on a daily basis for investors entering or exiting the fund.

28 **If the TWG recommend a CGT, it should also consider a CGT exemption for assets held within a PIE.**

29 If assets within a PIE are subject to CGT, the required daily calculations may well be unworkable, or at the least give rise to significant administration and compliance costs. PIE funds (and fund managers) will need a reasonable period to change their systems and governing documents to give effect to any such tax changes. We expect that a period of at least two to three years from the final legislation would be necessary to allow for the required changes.

30 **If, however, the TWG recommends that CGT applies to assets within a PIE, we consider there should be an option to calculate that tax on a deemed risk free rate of capital return.**

31 Any such method could approximate the long-term capital return on all relevant assets. While work would be need to be done to determine the appropriate rate, a long-term average inflation rate of return of say 1% to 2% would seem appropriate. We also note that the current 5% rate of FDR applying to determine income on equities would now, in the current environment, seem to be too high and should be reconsidered.

32 Finally, if CGT were to apply to assets in PIEs, it will be important that there is no further level of tax. We understand that the TWG are not proposing that sales of PIE interests will be subject to tax to the extent that they are currently exempt income and we agree with this approach.

Threshold for immediately deductible legal fees

33 We support the suggestion to increase the $10,000 limit for the automatic deduction for legal fees[7]. Determining the deductibility of legal fees places a compliance burden on both law firms and businesses.

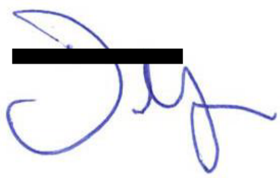
About DLA

34 DLA Piper is the first global, business law firm operating in New Zealand. We have 4,200 lawyers in the Americas, Asia Pacific, Europe and the Middle East, handling the most important legal needs of clients wherever they do business.

35 Our clients range from New Zealand's most significant organisations through to the world's most renowned global brands. Across every major sector and specialist practice, we provide innovative, commercially astute advice.

36 If you wish to discuss this submission further please contact David Johnston at
[1]

Yours faithfully,



David Johnston
Special Counsel
[1]

[7] Interim Report, page 108.