Tax Working Group Public Submissions Information Release

Release Document

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From: Mike Shaw [1]
Sent: Wednesday, 7 November 2018 2:38 PM
To: TWG Secretariat; Craig Elliffe; [1] Michelle Redington; Robin Oliver; [1]
Cc: Mike Shaw
Subject: Olivershaw submission
Attachments: submission Nov 18_.pdf

Hi

Attached is the submission from Olivershaw Limited. Robin did not contribute to this submission (he is too busy!).

Happy to discuss any aspect of it.

Regards

Mike

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7 November 2018

Tax Working Group
PO Box 3724
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Dear Sir

Submission

This is a submission by Olivershaw Limited to the Tax Working Group. One of the directors (Robin Oliver) of Olivershaw Limited is a member of that Tax Working Group. He was not in involved in this submission.

By way of background, my experience in tax policy includes a Director of Olivershaw Limited, a member of the 2009/2010 Victoria University Tax Working Group, a former senior tax partner at Deloitte, an independent adviser to five Ministers of Revenue, an adviser to the Corporate Taxpayers Group, a member of the CAANZ Tax Advisory Group. Originally, I was an accountant in a provincial city that specialised in farm accounting and many SMEs. I have also considerable commercial expertise having advised and invested in various successful start-up software companies. Our current client base includes start-up companies, established SMEs, listed companies, and high wealth individuals. We are recognised specialists in tax policy advice.

Finally, this submission is made on the basis of what I believe is the correct policy result, it is not being funded or influenced by any client.

Executive Summary

Having read the Interim Report by the TWG my comments are only in relation to the proposals regarding a capital gain tax (CGT).

Overall, I remain of the view that the existing fundamentals of the tax settings are about right and therefore extreme care should be taken when recommending any major change. Given our existing setting which are recognised through the world, any major change should be well considered, reasoned and fully justified. If the TWG has not completed this work, it should state this in its final report.

As stated in my previous submission, theoretically, before working through the detail, I see there is a case for a CGT. Post considering the design issues as outlined by the TWG, including the exemption for the family home, exemptions for most non-resident investment into New Zealand, the fiscal implications of the proposed CGT, the need for more investment outside residential housing, and the considerable increase in compliance costs, I am not convinced there are net gains from introducing a comprehensive CGT, possibly other than one targeted towards resident rental homes. (I see residential rental homes being an investment where capital gains are a reasonably safe expectation and therefore should be included in the tax net.) I see the following issues with a CGT on other asset classes:

1. The owner-occupied family home exemption is a significant barrier to a comprehensive CGT. This exemption simply will result in more expensive homes and less funds being invested in other investment classes such as start up businesses. The TWG seem to agree with this however rejected any consideration of the issue given its terms of reference. Given the growth in value of residential homes in our major cities, a comprehensive CGT as proposed will simply result in significant additional marginal investment going into owner occupied residential property. That is, many taxpayers will see the simplest method to build capital is to invest in their residential home. That is, a comprehensive CGT, but exempting residential homes, <u>will simply further skew investment into resident homes</u>.

2. The implications for the capital markets of the proposals are, potentially, considerable. It is not clear what the final recommendations will be, hence I comment on <u>what the TWG should **not** do</u>.
    a. An exemption or preferential treatment for PIEs. If there is any material preferential treatment for PIE investment over direct investment, it will simply distort investment in our capital markets. Conversely, if the taxation of PIEs is view more harsh than direct investment this will negatively impact on the 2.8million Kiwisaver investors which will also not support further investment into the capital markets. This area requires careful judgement and more consultation to ensure the best outcome.
        i. Given the work to date, it seems that if a CGT is progressed, on balance, the best viable solution for PIEs is the application of the FDR with a full credit for any imputation credits attached to dividends received by the PIE.
        ii. This seems the only practical solution unless CGT is deferred for a number of years to allow system changes or political acceptance of an accrued CGT.

    b. An **in**appropriate low FDR rate could also result in some of our corporates deciding that the NZ shareholders will face a lower tax outcome by the corporate becoming a non-resident company and its shareholders then being subject to FDR as opposed to both dividend and a realised capital gains tax. This would be a disastrous result for New Zealand capital markets.

    c. Changes that will reduce capital invested by direct shareholders (i.e. mum and dad investors). This could be due to the complexity or compliance costs imposed on such investors. This will skew the capital markets towards having only non-resident and PIE funds as investors. This would be a disastrous result for New Zealand capital markets

3. Limiting ring fencing of CGT losses. If there is a CGT which is fair, then losses have to be deductible against either capital gains or revenue gains, that is there has to be no (or limited) loss ring fencing rules. To recommend otherwise would result in a very unfair tax regime, namely taxing gains with most losses being ring fenced (I refer to my earlier submission for examples on this). This is a significant issue. I have considerable concern that officials or the government will restrict CGT losses to only being claimed against CGT gains. This will be justified on revenue grounds or to limit the risks to the existing income tax base. If the TWG recommends a CGT, it is important to comment whether that support is on the basis of having no (or limited) loss ring fencing. That is, if the government introduces a CGT with loss ring fencing, would this be something that the TWG would support and how this should be regarded as to the fairness of the tax settings.

4. To make a considered decision whether to support a CGT I believe the full details of the proposed CGT regime must be known and evaluated. The Interim Report was comprehensive however it left many issues outstanding. The real issues with a CGT are the practical issues and various exemptions and other settings. Further detailed work has to be undertaken before the TWG is in an informed position. Ideally the TWG should seek feedback on this, however the timeframes will not allow this to occur. Currently, there are simply to many outstanding issues that need further consideration. When major tax reforms such as this, consultation has generally involved two rounds of discussion documents. The interim report, while comprehensive, still left many issues with no firm proposals and hence it is difficult to comment on the overall package. The areas to date that require further detailed consultation include:
    a. The PIE rules as noted above.
    b. The loss ring fencing rules as noted above.
    c. The taxation of livestock. Farmers represent a large portion of our SMEs and most farmers use the herd scheme to value livestock for tax purposes. It is accepted the herd scheme is not consistent with a CGT. There is no proposal how to replace the herd scheme and that requires detailed and considered consultation. The National Standard Cost regime requires assumptions that are not required with the herd scheme, these assumptions need detailed consideration.
    d. Land development expenditure. With a comprehensive CGT, further work needs to be given to allowing depreciation to be claimed on farm development expenditure at purchase values as opposed to historic values by previous owners. To continue with allowing only historic values of previous owners seems totally inconsistent with CGT. This needs further consultation.
    e. Whether there is a de minimis exemption and what happens with the existing $50,000 de minimis exemption from the FDR regime. A CGT will significantly and materially increase compliance costs and may result in many direct shareholders (i.e. mum and dad shareholders) exiting the capital markets.

f. Corporate restructurers including amalgamations, de-mergers, roll over relief, share repurchases, treasury stock needs detailed consultation.
g. Resolving black hole expenditure. With a comprehensive CGT then all business expenditure should be deductible. Currently there is considerable concern over black hole expenditure. Ideally under a CGT, all black hole expenditure should be immediately tax deductible.
h. The tax treatment of bad debt deduction on financial arrangements which are currently not tax deductible needs to be considered. With a comprehensive CGT, it seems that all bad debt deductions should become tax deductible. This requires further evaluation.

5. Before final consideration is given to a CGT, the TWG should also consider what is the effect of a CGT on investment decisions. <u>A number of issues are very concerning</u>. The macro issues that should be considered include:
    a. The implications of the exemption for the family home as noted above
    b. Whether any corporates will determine that the tax implications for shareholders are reduced <u>should the company leave New Zealand</u>.
    c. Whether high wealth New Zealanders may determine that it is better that they reside out of New Zealand. In this regard, most high wealth New Zealanders (other than those who have invested their wealth in New Zealand real property) will be able to reside in Australia, spend up to 6 months in New Zealand and <u>not be subject to CGT in NZ or Australia</u>. We are concerned that the proposed CGT will result in some entrepreneurs exiting from New Zealand which will reduce employment and growth prospects for New Zealand.
    d. The incentives on the government with a CGT should be considered. A CGT will clearly, albeit in the long term, provide additional revenue for the government (expected to be c$6Billion after ten years). This simply provides more money for the government to spend. That is, in all likelihood this revenue will simply support additional expenditures especially noting that it will not eventuate for a number of years. The concerning issue is that when a market correction occurs, the government revenue that will cease to occur will be that from the CGT tax base. That is, when the Government needs revenue the most in a market correction, the first amount of revenue which will totally disappear will be the CGT tax base. This will have negative implications on interest rates. New Zealand has historically been protected from this given it did not have a CGT base in prior market corrections. The TWG should take this into consideration when it evaluates the merits of a CGT. It would seem preferable that GST rates are increased (with corresponding relief for low income earners) or simply increasing income tax rates. These tax bases are considerably more certain than a CGT base. For this reason, FDR would seem to be more attractive for the government as opposed to a realised CGT on equity investments for the PIE investors.
    e. Whether the proposals are too harsh compared with other CGT regimes around the world. For example, Australia only taxes 50% of the gain, has various exemptions and roll over relief and their superannuation regime (which materially reduces taxes on savings). For many New Zealanders, Australia will be an attractive destination given it (Australia) will exempt most

New Zealanders from CGT and of course New Zealand will not tax these expats as they will become non-residents.

Should the TWG progress with a recommendation for the imposition of a CGT, then I recommend the following changes based on the proposals that have been put forward in the interim report:

6. The valuation day option should not progress.
    a. The cost of the initial valuation will be in excess of $1b, possibly well above $1b, possibly has high as $2 to $3billion. See the number in the table below (I have sought advice from valuers regarding their level of fees for residential and commercial property valuations including valuations in provincial New Zealand). This level of costs compared with the revenue that may be collected is unwarranted.

Asset	Number of valuations	Cost for Val.	$m valuation cost estimate
Rental homes	600,000 (say 500,000)	$600.00	300
Enterprises	534,000 (say 500,000)	$2,000.00	1,000
Second homes and holiday homes	?		
Minority share valuations	?		
Lifestyle blocks	?		
Total cost (conservative est.)			$1.3billion

    b. Adjusting for the above conservative estimates, the total cost on taxpayers of the valuation day option could be $2-3billion.
    c. Even if the cost of the valuation was acceptable to the government, New Zealand simply does not have sufficient valuers to undertake the work that would be required. This would shortage of supply of valuers would result in either sub-standard valuations and/or valuers coming in from other countries.
    d. Valuation is an art, it is not a precise science. Given the implications of the opening value for CGT purposes, there would be general pressure by taxpayers for valuers to provide valuations at the top end of possible valuation ranges. This will materially reduce the income that has been forecast to arrive under a CGT.
    e. Valuations of property are clearly easier to obtain than business valuations. Business valuations are considerably more complex and materially more expensive with the availability of qualified valuers considerably less. This raises the costs and the likelihood that most valuations will be disputed by the Inland Revenue. Take for example the valuation of Xero. Xero currently makes losses but as a valuation of more than $5billion. Many taxpayers will use this as the benchmark how to value their business.
    f. In summary, the valuation day approach is simply very costly and very uncertain with the implications that there will be many disputes with the IRD.

g. I recommend the TWG revert to the Australian approach and apply CGT to all assets acquired post commencement date. If it wants to pursue a targeted CGT at residential rental houses, then maybe this could be done on a valuation day basis. Further consultation should be undertaken whether this is achievable.

7. Tax depreciation should be reinstated for all commercial and industrial buildings. Officials (latest) advice is reasoned and compelling. The previous National Government removed all tax deprecation on such buildings based on incorrect advice by officials. This should be a high priority to reverse given the points outlined by officials and is unrelated to CGT. When the depreciation deductions ceased the corporate tax rate was also reduced to 28%. If fiscal considerations are an issue, it would seem logical that the building depreciation is turned on and the corporate tax rate increased back to 30%. As I outlined in my original submission, the best policy outcome would be to align the top personal rate with the corporate rate. I would modify this to take into account depreciation on buildings to determine the appropriate aligned tax rate.
    a. Related to the above is the position with seismic costs. The current position is clearly unacceptable and requires urgent attention. This has, inadvertently, been made worst by the interim report of the TWG. This is because the tax uncertainty now has a bias for property owners to cease any seismic expenditure as that may only become tax deductible if incurred after a future date. The TWG and government should urgently clarify the rules so that building owners know with certainty what the tax consequences are of their expenditures to address seismic issues.

8. Ideally some adjustment should be made for not taxing the inflation portion of any gain. It simply does not seem appropriate (or fair) that CGT will apply to the entire gain including inflation changes. Most countries CGT regime reflect this directly or indirectly.

I am happy to provide further information on the above comments.

I am happy to discuss our conclusion above.

Yours faithfully
Olivershaw Limited

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Mike Shaw
Director

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