

EMBARGOED UNTIL 5 PM TUESDAY 19 DECEMBER 1989

HON DAVID CAYGILL
MINISTER OF FINANCE

LAUNCH OF THE CONSULTATIVE DOCUMENT
ON THE TAXATION OF INCOME FROM CAPITAL

PARLIAMENT BUILDINGS

TUESDAY 19 DECEMBER 1989

Since 1984 the Government has dramatically overhauled the tax system.

Often we have acted in line with reports and recommendations that had largely been ignored in the past.

The key difference since 1984 has not been so much in the way in which we have changed the tax system as the fact that this Government has had the courage to make these changes.

This document comprehensively reviews the taxation of income from capital. In doing so it addresses two of the more important issues where reforms have been called for in the past.

- * the exemption from tax of income derived from increases in the value of assets
- * the lack of adjustment for inflation when taxable income is calculated

The questions the document poses are quite simple:

Is it fair that some income from holding property or shares should be tax free, while income from personal effort is fully taxed?

Equally, is it fair that tax is assessed on income which merely compensates taxpayers for inflation?

It's these questions that the Government is inviting New Zealanders to consider now.

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The present tax system is very uneven in its treatment of income from capital.

For example, at the moment there are provisions for the taxation of income from

- the sale of property acquired for the purpose of resale
- the sale of land by a developer, dealer or builder
- the sale of intellectual property rights
- ordinary bank accounts, debt instruments and other financial arrangements

Ordinary bank accounts are relatively comprehensively taxed.

On the other hand, liability for tax on other types of property often depends on the personal intentions of the taxpayer, the nature of other activities carried out by the taxpayer, and how long the property is held.

As the Consultative document points out, investments which are not attractive in their own right can be attractive merely because the income they produce is untaxed.

The tax exemption therefore encourages investment in areas offering low pre-tax returns.

On that basis, and on the basis that the advantage of existing concessions is greatest for those with most wealth, it is both efficient and fair to include currently untaxed income in taxable income.

Whether changes in the value of personal assets - houses, cars, paintings, boats - should also be included is discussed at length in the document.

The document concludes that changes in value of ordinary household assets which people buy to use should remain outside the tax system.

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As to the position of the family home.

Under the proposals put forward in this document, most ordinary family homes would not incur any tax liability.

I believe that is entirely appropriate, since most homeowners only realise a capital gain on their home at the point when they are about to buy another home.

However the Government has looked at this issue.

It wishes to put this matter beyond any doubt.

It has taken the following decision - that whatever happens to the proposals of the Consultative Document, family homes will not be subject to any form of capital gains tax.

This is the only decision we have taken on this Document other than the decision to release the document.

The Government will invite the Committee to consider the best means of giving effect to the Government's decision not to tax family homes.

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The second issue that the document addresses is the effect of inflation on the tax system.

At present, when taxable income is calculated, no allowance is made for inflation. The present system taxes both the real and inflationary component of income to varying extents.

Quite clearly there would be potentially enormous benefits for all taxpayers from a comprehensive indexation of the tax system.

Savers would pay less tax on their interest.

Businesses with trading stock would be entitled to a deduction for the impact of inflation on their stock.

Depreciation allowances would be similarly increased by the rate of inflation.

And of course any tax liability on the sale of assets would be calculated on an inflation-adjusted basis.

The document makes it clear that some form of indexation or inflation adjustment is not only desirable, but practicable.

It is a complex area, but there are a number of possible approaches.

I expect them to be thoroughly considered by the Consultative Committee.

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So. The two issues that we are throwing open now for consideration and debate are these:

- * the extent to which it is feasible and reasonable to tax capital income currently left untaxed.

- * secondly, the desirability and practicality of indexing income for inflation

This document provides an excellent basis for that discussion. It sets out the issues clearly and in great detail.

I believe that we can now have a sensible and reasoned debate.

Perhaps I can leave you with the recommendation of an earlier Tax Committee

"We consider that the introduction of a realised capital gains tax is desirable on the grounds of equity, provided the rates of tax are moderate. However, we do not consider that the tax should be imposed before the other recommendations of this Report have been implemented. Furthermore, as the matter is complex and difficult, members of the public should be given the opportunity to make representations before a final decision is made on the introduction, form and structure of the tax."

That was the recommendation of the Ross Committee in 1967.

I say we have done exactly that.



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DOCUMENT PROPOSES RATIONALISATION OF TAX ON CAPITAL INCOME

"The present tax treatment of income from capital is a mess. It is widely acknowledged to be capable of substantial improvement.

"In particular, as the Consultative Document that I am releasing today concludes, there is little rational basis for the current exemptions from taxation of some forms of income."

"The Document observes that the present tax system is very uneven in its treatment of some forms of income from capital, particularly 'capital gains'.

"As it points out, some capital gains are currently subject to tax while others are not.

"The present exemptions are not the result of any specific legislative action by Parliament. Instead they are largely the result of past decisions of judges, who have relied on legal precedents from trust law to define income under the Income Tax Act.

"As the Document suggests, there is little reason to believe that the line that is now drawn between taxed and untaxed income has any inherent justification.

"Accordingly it proposes that income should be made assessable - irrespective of what label is attached to it - whether it is income from capital, wages, salary or other sources.

"The situation as it stands is quite simply unfair. Some people are caught by the tax net while others go free.

"It's what you get, not how you get it' that should count for tax purposes."

"It may be that some exceptions from this broad principle are justified. The Government has already made the decision that income from the sale of family homes will not be liable to tax.

"The task of the Consultative Committee is to examine all of the current exemptions - bearing in mind that it is the Government's aim to make the tax system fairer and more efficient.

"If at the end of the day, it is decided to retain certain exemptions, this will be the outcome of a comprehensive and careful review.



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CONSULTATIVE COMMITTEE WILL HAVE KEY ROLE

Finance Minister David Caygill today named the Consultative Committee to consider the issues, hear submissions, and make recommendations on the taxation of income from capital.

The Committee will comprise:

Mr Arthur Valabh (Chair)
Deloitte Haskins and Sells

Dr Robin Congreve
Company Director

Mr Rob McLeod
Arthur Andersen and Company

Mr Lindsay McKay
Chapman Tripp Sheffield Young

Mr Tim Robinson
Jarden Morgan

"The Committee will have a considerable responsibility," Mr Caygill said.

"The area of reform is wider and the issues are more complex than many previous areas of reform. That is why I have given the Committee plenty of time to undertake their work.

"I have asked the Committee to consider the policy issues involved in the proposed reforms, as well as the technical and operational details.

"I am keen to see a thorough and rational analysis of all the current exemptions from tax on capital income. If the Government decides at the end of the day to retain some exemptions it will do so in the context of an overall review - unlike the previous piecemeal approaches to reform in this area.

"The proposed application of indexation to various categories of income from capital sources will also have to be carefully examined, particularly in the complex area of financial arrangements. Before proceeding, the Government will want to be fully satisfied that the proposed indexation system is practical and can be implemented without undue administrative and compliance costs.

"Such an agenda will take some time to work through. Accordingly, interested parties will have until 31 May 1990 to make submissions to the Committee," Mr Caygill said.

The Committee has been asked to report to the Government by 1 December 1990. No legislation will be introduced on these matters before 1991.



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FAMILY HOMES WILL NOT BE LIABLE TO CAPITAL GAINS TAX

"The Government has decided that family homes will not be liable to tax on their sale - whatever happens to the proposals in the Consultative Document," Finance Minister David Caygill said today.

"The Consultative Document released today is a discussion document. It proposes one method whereby most ordinary family homes would be exempt from tax on sale.

"The approach the Consultative Document recommends is to include the proceeds from the sale of a home as income for tax purposes, but to allow a deduction for the original purchase price, inflation over the period of ownership, and the costs of capital improvements or a standard allowance for each year of ownership.

"From historical house price data it seems clear that the proposed system would remove most ordinary homes from tax liability.

"The Consultative Document also argues that excluding housing altogether from the tax net would create a tax shelter which would encourage over-investment in housing and push up house prices - thus making it more difficult for people to own their own homes.

"Whether the argument against a complete exemption for housing has merit, and whether the proposed system of effectively exempting family homes is the most appropriate are matters for public submission to and consideration by the Consultative Committee.

"For its part, the Government has resolved that family homes will remain exempt from tax on any capital gain - just as they are in almost every other country," Mr Caygill said.



19 December 1989

INDEXING THE TAX BASE FOR INFLATION PROPOSED

"A major part of the Consultative Committee's work will be to look at the practical implications of indexing the tax base for inflation," Mr Caygill said today.

"If we are able to achieve this, it will be of enormous benefit to all taxpayers.

"The consultative document concludes that indexation would be highly desirable, but it concedes that there are some practical difficulties.

"Nevertheless it proposes a number of significant steps that can be taken in this direction: steps that would remove many of the distortionary effects of inflation on the current tax system.

"The document proposes inflation indexation in these areas:

- * income from the sale or disposal of assets. The original cost and any subsequent capital expenditure would be adjusted for inflation.
- * income from the sale of trading stock. Indexation would reduce taxable income by an amount which is approximately equal to the average stock on hand over the year multiplied by the inflation rate over that period.
- * depreciation allowances would be based on the purchase price of the asset adjusted for inflation since purchase.
- * Interest income and expense would be indexed so that only the real, inflation-adjusted component of interest income would be assessable or deductible.

"These proposals will go a long way towards reducing our artificially high effective tax rates," Mr Caygill said.



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SAVERS WILL GAIN FROM INFLATION INDEXATION

Tax on interest will be cut if proposals outlined in the Consultative Document are implemented, Finance Minister David Caygill said today.

"A major part of the Consultative Committee's work will be to examine the practicality of indexing the tax base for inflation.

If that is achieved, it will have major benefits for all New Zealanders.

"The present tax system is particularly unfair to savers. They lose out in two ways. They are disadvantaged because they pay tax on their interest, while profits from selling property and shares are often not subject to income tax at all.

"And they lose out because they pay tax on all the interest they receive, even though part of that income merely compensates them for inflation.

"The Consultative Document tackles both these problems.

"By bringing profits from selling property and shares into the tax net, savers and investors would be treated the same.

"By adjusting income from capital for inflation before taxing that income, savers and investors would be taxed only on their real income.

For example:

"Suppose a taxpayer puts \$1000 on a one year term deposit at 10% interest at a time when inflation is running at 5%. At the end of the year, that person receives \$100 in interest - but inflation has eroded the value of the original \$1000 by \$50.

"The taxpayer's real gain is only \$50 - that is the \$100 interest, minus the \$50 lost purchasing power caused by inflation.

"Under the present system, the Government taxes all of the \$100 paid as interest.

"If today's proposals are put in place, the Government would tax only the \$50.

"In this case, the tax on interest would be halved.

"Comprehensive indexation of the tax system is complex, but I believe that the principle is sound.

"If it can be done in a way that minimises the cost to taxpayers of complying with the proposals and if the administration of the system is not unduly costly or complex, it will mark a significant step forward in this country's tax policy," Mr Caygill said.



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REFORMS WILL BENEFIT INVESTMENT

"The effect of the proposals announced today will be to significantly improve the quality of investment in New Zealand,"

Finance Minister David Caygill said today.

"It will do so in two ways:

- * eliminating tax on inflationary gains on all business assets, including trading stock and depreciable assets will encourage productive investment.
- * encouraging entrepreneurs to consider the real profitability of their investments, rather than to pursue tax breaks will see money going back into those areas where it will do most good.

"There have been dire predictions over recent weeks that a more rational approach to taxing capital income would lead to the death of entrepreneurial spirit. That is nonsense.

"These dramatic statements ignore a simple point. The risk an entrepreneur takes when embarking on a venture is not itself a benefit. If a project fails, the sunk costs are a loss to investors and to the community as a whole.

"These statements are also contradicted by the fact that the Consultative Document's proposals as a whole would reduce the Government's tax revenue - leaving more money in the community to be spent or invested.

"In the past, tax loopholes have encouraged some investors to put their money in projects that were not sound. By closing these loopholes, we will encourage entrepreneurs to keep their eyes on their actual objective, which is making a real profit.

"That will be to everyone's benefit," Mr Caygill said.