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THE TAXATION OF INCOME FROM CAPITAL

AN OVERVIEW

DECEMBER 1989



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Preface

OFFICE OF MINISTER OF FINANCE
WELLINGTON, N.Z.

STATEMENT BY THE MINISTER OF FINANCE

Introduction

Since 1984, the Government has progressively reformed the tax system. The objective has been to make the system fairer and less distorting. Substantial progress has been made. Indeed, the OECD reported in 1989 that New Zealand's income tax system "is now probably the least distorting in the OECD".

Despite these achievements, there is widespread recognition that certain aspects of the tax system remain unsatisfactory. This is especially true of the taxation of income from capital.

Depending on the form that they take, the real returns from saving and investment may be undertaxed (with some forms escaping taxation altogether) or they may be overtaxed. While it goes without saying that such anomalies can be grossly unfair, they also, and just as seriously, have the potential to degrade the quality of investment. When this occurs, economic growth is retarded and future living standards are damaged.

The Consultative Document is the outcome of a comprehensive review of the current tax treatment of income from capital. Its central focus is to identify the aspects of the present tax treatment of income from capital which are unfair and inefficient. Reforms are outlined which will assist in rectifying the identified deficiencies.

There has been a widespread expectation that the Document and the forthcoming consultative process would deal only with the taxation of capital gains. It would of course be possible to graft a "capital gains tax" onto the existing income tax. Some other countries have done that.

The Government has rejected a patchwork approach. Instead, it has opted to undertake a comprehensive review of the tax treatment of income from capital. We are not interested in simply adding another tax to the list. Rather we are concerned to ensure that the existing income tax treatment of income from capital is rationalised in a fully consistent, predictable and integrated manner.

Our review of the taxation of income from capital has identified two major deficiencies in the present tax system. First, certain forms of income from capital presently escape taxation for reasons which are often capricious, are likely to be arbitrary and will almost certainly be divorced from underlying economic realities. Advocates of a capital gains tax have drawn attention to some of these exemptions.

The second major deficiency of the present tax treatment of income from capital results from the interaction of taxation and inflation. Ideally, purely inflationary gains, unrelated to any increase in capacity to pay, should not be swept up in the income tax net. However, fictitious inflationary gains are taxed, to varying degrees, by the present system. The resulting over-taxation of real capital income varies according to the type of asset and the form of income it generates and is greater the higher the rate of inflation. Ad hoc remedies in the form of investment allowances and schemes of accelerated depreciation have sometimes been adopted as stop-gap solutions to these problems.

These two major deficiencies in the taxation of income from capital are obviously not unrelated. For example, capital income exemptions are sometimes defended, not on their own terms, but because they do guarantee that purely inflationary gains are not taxed. The Government believes that the two major identified deficiencies of the capital income tax base cannot be considered in isolation but must be tackled simultaneously and in a properly integrated manner.

Status of the Consultative Document

A consultative process is a well-established feature of this Government's tax reform programme. Under this process, the Government's objectives and general direction of reform have been set out in consultative documents. Many of the technical and operational details have been left open, to be decided by the Government once submissions and the consultative committee's report have been carefully considered.

This is the approach adopted in this instance. The Government is committed to the objective of reforming the income tax system to make it more equitable and to promote efficient, rather than tax-driven, investment decisions. We are committed to removing the distorting effects of tax exemptions and concessions. We are committed to minimising the distorting effects of the interaction of inflation and taxation on the incentives to save and invest. The reforms set out in the Document are directed at these objectives.

We will not, however, make final decisions until we have fully considered the submissions of interested parties and the report of the Consultative Committee. When we do, these decisions will be guided by the objectives outlined in the previous paragraph.

Removal of Tax Exemptions

A major focus of the Document is the present exemption of specific forms of income. The most prominent type of income in this category is usually called "income on capital account" or, more colloquially, "capital gains". The present exemption of certain types of capital income is not the result of any specific legislative act of parliament. Instead, it is the result of a long sequence of judicial interpretations drawing upon concepts that had evolved in an unrelated area of

trust law.

Notably, none of the significant inquiries into tax matters (i.e., the Ross Committee in 1967, the McCaw Task Force of 1982, the Brash Committee of 1987 and most recently the Valabh Committee of 1988) was able to find any sound principle underpinning these aspects of the present law.

Indeed, the current law can be viewed as an accident of history. Because the law lacks any coherent basis, judges have declared that it is very difficult to interpret. Moreover, since the very beginning of the income tax system, the distinction between taxed and untaxed forms of income has been progressively modified by specific legislation to the point where the system now taxes many forms of income from capital. There has, however, been no comprehensive review dealing simultaneously with all forms of income from capital. Accordingly, there is little reason to believe that the line which is now drawn between taxed and untaxed income has any inherent justification. The system is badly in need of clarification based on rational criteria.

While there will be differences of opinion on the extent of the necessary reforms, informed commentators agree that there is ample room for improvement. The present law is not fair. There are arbitrary distinctions between people in similar circumstances. The present law is not clear. It is open to manipulation and cannot be administered effectively. As a result, some large businesses pay no tax.

No one can reasonably defend the present arbitrary and confused set of rules. The key issue is the extent of the reforms necessary. The Government has made no final decision on this.

We are not, however, seeking to introduce a new and separate tax on income that happens to be called "capital gain". Some other countries, such as Australia, the United Kingdom and Canada, do have capital gains tax regimes which are more or less separate from their income tax. The Government does not intend to pursue this approach.

Instead, we aim to improve the effectiveness of the income tax system. We will carefully work through the current law to decide whether the present exemptions are justified. If, at the end of the day, it is decided to retain certain exemptions, this will be the outcome of a comprehensive and rational analysis, rather than the result of a series of unco-ordinated decisions extending over many decades, as has been the case in the past.

The removal of certain exemptions would mean that income which is now classified as tax-free capital gain would become taxable. Some may wish to characterise the removal of such exemptions as the introduction of a "capital gains tax". The Government has no difficulty with that, except to note that in a very real sense this characterisation misses the point.

The real issue is that the present tax treatment of income from capital is a mess. It is widely acknowledged to be capable of substantial improvement. We can and should make it fairer. We can and should make it more conducive to forms of investment which will promote employment and improve our living standards.

The Interaction of Inflation and Taxation

No comprehensive analysis of the impact of the present tax system on saving and investment can ignore the impact of inflation on tax liabilities. Accordingly, the Document includes a thorough analysis of the impact of inflation on the taxation of capital income.

Governments both in New Zealand and other countries have frequently relied on inflation to fund increases in expenditure. Even low rates of inflation can produce a marked increase in the tax impost on saving and investment. Incentives to save and invest, and thereby the rates of economic growth and job creation, are depressed accordingly. Any inquiry into the effect of the tax system on saving and investment must analyse the interaction of inflation and taxation.

Not surprisingly, taxpayers seek relief from inflationary tax imposts. Various measures, such as investment and accelerated depreciation allowances, have been introduced in the past to mitigate the tax effects of inflation. These ad hoc measures do not, however, address the root of the problem. Indeed they can make things worse by introducing yet more biases into the tax system. Moreover, while they are often slow to be introduced, they can subsequently assume a life of their own so that, long after their original rationale has disappeared, they may be difficult to remove. Thus, one of the damaging side effects of inflation on the tax system is the pressure for the introduction of ad hoc measures to reduce its impact.

A preferable approach is to address the fundamental cause of the problem - the fact that the tax system makes no systematic allowance for inflation. Hence, one of the principal concerns of the Consultative Document is to examine the practicality of comprehensively indexing the taxation of capital income. In 1982, the McCaw Task Force on Tax Reform urged the previous government to undertake just such a review.

The Government's willingness to consider indexation does not indicate that its determination to eliminate inflation is in any way reduced. On the contrary, indexation would be a further demonstration of the Government's resolve. As mentioned previously, governments can achieve unlegislated increases in taxation by failing to control inflation. Their ability to do so would be much more limited if the tax base were fully indexed. The major revenue incentive for this or any future government to slacken its anti-inflationary stance would be substantially reduced by a fully-indexed tax system.

I am confident that the Government will succeed in its resolve to reduce inflation to the target range of 0-2% and maintain it at these levels. We have amended the Reserve Bank Act and taken other steps to increase our ability to meet this goal. Once that has been achieved, fluctuations in inflation would have only a minor impact on tax liabilities. This is as it should be.

Against the background of the Government's firm anti-inflationary policy, indexation of the tax base should be seen as an insurance policy. If the tax base were indexed, taxpayers would be protected against inflationary increases in tax burdens should any future government follow a path of fiscal irresponsibility. Savers and investors will be able to plan far more confidently for the future and governments, in their turn, will have much less incentive to betray their trust.

The Government has made no decision to index part or all of the tax system. We do, however, believe that indexation should be thoroughly examined by the Consultative Committee. The administrative and compliance implications need to be carefully considered. In addition, there are a number of complex practical issues relating to the indexation of financial arrangements that need to be addressed and resolved.

An important part of the Consultative Committee's task will be to examine these areas.

Effect on Savings and Investment

Over recent months, there has been criticism of capital gains taxes on the grounds that they discourage saving and investment. This argument is addressed fully in the Document. I mention only the main points here.

First, as noted above, there is no sensible distinction between returns in the form of "income" and those in the form of "capital gains". In an economic sense and in the way ordinary savers and investors view matters, real capital gains are just another form of income. If taxing real capital gains discourages saving and investment, then taxing income must do so also.

The Government acknowledges that an income tax does in fact discourage saving and investment by reducing the return that the saver or investor receives. These disincentive effects of an income tax depend on the tax rates. Lower tax rates mean lower disincentives. The honest way to minimise the disincentive problem is to broaden the tax base and lower tax rates. Not only is the continued exemption of certain forms of capital income an invitation to abuse the tax system, but by contributing to higher tax rates, the exemptions exacerbate the disincentive problem.

Secondly, and even more importantly, the criticism entirely misses the point that tax exemptions and concessions do much more to distort the pattern and lower the quality of saving and investment than they do to alter its quantity.

Tax concessions are rapidly reflected in the market values of particular types of assets. This occurs because investors alter their investments to take advantage of the tax concessions. The prices of assets which are expected to produce untaxed income are then pushed up relative to those which produce fully-taxed income. These price differences stimulate investment in the tax-favoured activities. At the same time, other avenues of investment with higher pre-tax returns (indicating that they have more to contribute to national welfare) are passed over.

Once this process is complete, the expected after-tax rate of return (adjusted for risk) on all types of assets must be approximately the same, irrespective of the way in which their returns are taxed. However, the pattern of investment has changed in a way which is counter to the nation's interest.

New Zealanders have seen this type of effect. For example, in the past the price of farmland has been artificially inflated by tax concessions and a variety of explicit government subsidies. These subsidies drove up the price of land, made it more difficult for new farmers to enter the industry, stimulated the development of economically unproductive land and encouraged farmers to take on levels of debt which in many cases could not be serviced from farm income.

The previous government attempted to address these problems by introducing yet more subsidies. It was obvious that this approach could not be sustained. The only sensible policy was to phase out the subsidies and reduce tax rates, as this Government has done.

In summary, the exemption of certain forms of income has a detrimental rather than a positive effect on the pattern of saving and investment. Investment is channelled towards tax-favoured areas. It comes to be motivated by tax considerations rather than by profitability based on market returns. It is obvious that investment which is profitable in the absence of subsidies and concessions offers most to New Zealand. We cannot make New Zealand wealthier simply by giving tax concessions to one group of investors at the expense of higher taxes on another. Taken together, the reforms outlined in the Document are entirely consistent with the objective of promoting saving and profitable (as distinct from tax-motivated) investment.

Personal Residences

An important category of assets are houses and other types of dwellings acquired for the personal use of their owners. Historical data for the period from 1962 to 1988 indicate that the price of houses has increased, after allowing for the effects of inflation, by an average annual rate of 0.7%. As might be expected, the rate of increase has varied between different towns and cities and different time periods. Nevertheless, the average rate of increase, after adjusting for inflation, has been small. Indeed, the above data exaggerates the real capital gain because it does not adequately allow for home improvements which would be deductible for tax purposes.

This evidence suggests that real gains on most houses are likely to be relatively small, while the compliance and administrative costs involved in attempting to measure them accurately are likely to be relatively large.

Nevertheless, there are sound reasons for not providing a blanket exemption for personal residences. A blanket exemption would enable higher-income taxpayers, who would be most affected by the reforms outlined in the Document, to escape the effect of the reforms by increasing their already large investment in higher-priced housing. Higher-priced houses have increased in value in Australia following the total exemption of personal residences from the Australian capital gains tax. The total exemption of personal residences would also allow speculators in houses and "professional" home renovators to make substantial tax-free income.

The Government does not think it right to encourage these forms of tax avoidance. The Consultative Document proposes that gains or profits, excluding purely inflationary gains, derived on the sale of houses and other personal dwellings should be assessable. However, in order to target the areas of concern while ensuring that most ordinary homes do not give rise to a tax liability on sale, it is proposed that a standard annual allowance set at an appropriate level (say, \$4,000) should be able to be added to the acquisition cost of a taxpayer's principal residence. Any inflation-adjusted profit on sale would be measured relative to this augmented cost.

These proposals would mean that only profits on more expensive homes and those which increase in real value at high rates would give rise to a tax liability on sale. Further consideration can be given to this matter by the Consultative Committee to ensure that the best means is adopted of meeting the overall objective of these reforms while at the same time ensuring that most ordinary homes do not give rise to a tax liability on sale.

Consultation

The Government has appointed a Consultative Committee to consider submissions on the reforms outlined in the Consultative Document. Because of the significance of the reforms, the Government expects that the public, tax practitioners and the Committee will require more time for the consultative process than has been the case previously. Accordingly, interested parties will have until 31 May 1990 to make submissions to the Committee. The Committee has been asked to report to the Government by 1 December 1990.

The Government is grateful for the assistance of the members of the Consultative Committee. The issues raised in the Document are complex and far reaching. I am confident that the Committee will fulfill its task in a competent and professional manner.

Conclusion

The Government commenced its business tax reform programme in 1984. New Zealand's income tax legislation is contained in the Income Tax Act 1976 which has as its basic framework the Land and Income Tax Act 1954. Prior to 1984, few substantive amendments had been made to this legislation since 1916.

In the intervening 68 years, much had changed in the business and commercial environment. Forms of remuneration had changed. Businesses had become more complex and internationally oriented. The financial sector had become much more sophisticated. For the most part, the income tax legislation had failed to keep pace with these changes. Much had to be done to bring it up to date. Since 1984, considerable progress has been made. The pace of change has no doubt been faster than some would have wished. In large part, this has been unavoidable, given the magnitude of the problems we have had to address and the failure of previous governments to tackle them.

The Government's overall objective has been to comprehensively review and update our income tax law, to protect the revenue base, to make the system fairer and to reduce its detrimental effect on incentives to work, save and invest. The resulting strengthening of the tax system has meant that the Government's revenue requirement is now being raised over a much wider tax base at much lower tax rates.

The proposed reforms outlined in the Consultative Document are the next major step in this tax reform programme. The Government invites public comment on the reforms. I commend the Document to all parties who may be affected and to those interested in the further reform of New Zealand's income tax system.



David Cargill
Minister of Finance
19 December 1989

OVERVIEW

TAXATION OF INCOME FROM CAPITAL

"The introduction of a realised capital gains tax is desirable on the grounds of equity provided the rates of tax are moderate. Such tax should not, however, be imposed until the other recommendations of this report have been implemented. Members of the public should be given the opportunity to make representations before a final decision is made by Government on the introduction, form, and structure of the tax."

Ross Committee on Tax Reform, 1967

I Introduction

The Minister of Finance, the Hon David Caygill, announced in the 1989 Budget that the Government would publish a discussion document this year on the reform of the taxation of income earned in the form of capital gains. The Consultative Document that has now been released addresses this issue in the context of a broad review of deficiencies in the current tax treatment of income from capital.

Income from capital is a wide term and includes income from all forms of saving and investment. Two central deficiencies with the current tax system are identified:

- it fails to tax all income which people derive; and
- it fails to ensure that inflation does not cause taxable income to be overstated.

The two issues are related and should not be considered in isolation. The Consultative Document explores in detail the extent to which these deficiencies can be rectified. Doing so would make the tax system fairer and reduce its adverse effects on saving and investment decisions.

This Overview outlines the key points contained in the Consultative Document. It does not purport to be an in-depth review of all the issues. Interested readers and those who wish to make submissions are encouraged to refer to a copy of the main Consultative Document.

The taxation system in New Zealand has been progressively overhauled since 1984 with the aim of meeting the Government's revenue requirements in a fairer and more efficient manner. The criteria according to which all tax reforms should be judged are:

- **Fairness**
The tax system should be seen to be fair. People receiving the same level of income should generally pay the same amount of tax, regardless of the source or form of their income. Taxpayers on high incomes have a greater ability to pay tax and should therefore pay higher amounts of tax.
- **Economic Efficiency**
Taxes should be collected in a manner that imposes the lowest possible economic costs. Poorly designed taxes create unnecessary economic costs which reduce living standards. For example, if certain categories of income are liable for taxation and other categories are not, the tax system creates an incentive for taxpayers with the means to do so to invest more in areas which will generate untaxed income. We would all be better off if investment decisions were less affected by taxes and more affected by profitability based on market returns.
- **International Compatibility**
A country's tax system should not favour investment by foreign nationals at the expense of its own taxpayers. Nor should it favour investment overseas by its own taxpayers at the expense of local investment.
- **Simplicity**
Finally, any taxation system imposes administrative costs upon the Government and compliance costs on taxpayers. These costs benefit no one and should be minimised.

There are often conflicts between these criteria. Inevitably, one must be traded off against another. A general rule which has guided recent New Zealand tax reforms is that a broadly based tax levied comprehensively at relatively low rates is likely to best meet the criteria for a good tax.

This is the principle underlying the successful implementation of GST. The principle applies equally well to income tax. If the income base on which tax is levied is relatively narrow, tax rates have to be higher to achieve government revenue targets. Conversely, if the income base is relatively broadly defined, tax rates can be set at lower levels to achieve a given revenue requirement.

New Zealand has made considerable progress in reforming the income tax system. This has meant that the Government's revenue requirement is now being raised over a much wider tax base at much lower tax rates. This is a substantial achievement. Indeed, the OECD reported in 1989 that New Zealand's income tax system "is now probably the least distorting in the OECD".

Even so, the taxation of income from capital has not previously been comprehensively addressed. The Consultative Document therefore marks an important step towards a fairer and better tax system.

II Key Aspects of the Consultative Document

The Consultative Document identifies a number of areas where the current treatment of income from capital is deficient and can be improved. Two significant and interrelated issues stand out:

- **There is no rational basis for the current exemptions from taxation of some forms of income.** The Consultative Document 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. This suggests that existing provisions of the Income Tax Act should be extended so that profits or gains on the sale of property, excluding profits or gains attributable to inflation, would generally be taxable;
- **Problems flow from the interaction of the tax system with inflation.** Methods of correcting this deficiency by indexing the income tax system are outlined. This would mean that, for tax purposes, income from gains on the sale of property would be measured by deducting any inflationary component. Depreciation would be calculated on the indexed value of assets and not their historical cost book values. The value of trading stock would be adjusted for inflation so that businesses are not taxed on profits which are attributable to inflation. Interest would also be adjusted for tax purposes to exclude the effects of inflation. However, there are significant compliance problems in indexing interest which would first need to be addressed.

III Removing Income Tax Exemptions

The Exemptions for Income from Capital have No Inherent Rationale

Current law does not tax some types of income. The main category is colloquially known as income in the form of "capital gains".

The exemption of this form of income is not the result of any specific legislative action by Parliament. Instead, it is 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 1988 Royal Commission on Social Policy noted, this approach provides little rationale for determining a person's income tax liability.

The exemptions of some types of income from capital are not related to the way people view investment decisions or their economic position. Income derived from the realisation of gains on assets when they are sold is fundamentally the same as income derived from wages, interest or dividends. This causes considerable difficulties for the courts in drawing the boundary between taxable and non-taxable income. One of New Zealand's leading judges, Sir Ivor Richardson, has declared that drawing the boundary is "an intellectual minefield in which the principles are elusive and the analogies treacherous".

Changes to the Exemptions Over Time

Parliament has frequently decided that adherence to this distinction between taxed and untaxed income cannot be justified. Over time, the exemption has been progressively reduced on an ad hoc basis by specific legislation. Thus, we now have an income tax system which does tax many forms of income derived on the disposal of property. Examples include:

- most profits or gains from the sale of property acquired for the purpose of resale (implemented in 1916);
- profits from the sale of land derived by a dealer, developer or builder (1973);
- most gains from intellectual property rights (1980); and
- most gains made on debt instruments and other financial arrangements (1986).

However, other forms of income from capital are still frequently exempt from tax. Existing provisions in this area tend to be narrowly targeted. They often depend upon the personal intentions of the taxpayer, the nature of other activities carried out by the taxpayer, the taxpayer's associates and how long the property is held. As a result, income from the sale of assets (land, buildings, shares and various forms of goodwill) is frequently not subject to tax.

There are sound reasons for removing the present exemptions.

- **The Exemptions Adversely Affect Saving and Investment**

Investments which produce untaxed income are artificially attractive. The taxation advantages divert investment away from higher-return areas. If we want to improve our living standards we should not let the tax system artificially promote investment in selected areas by making them more profitable through concessions and exemptions.

- **The Exemptions Make the Tax System Unfair**

The exemptions mean that people earning the same income do not pay the same tax, and some people on higher incomes pay less tax than those on lower incomes. This is unfair. Those who own the most capital obviously benefit most from the exemptions. There are no statistics to analyse the distribution of capital income among New Zealanders. But the overseas data shows that on people on high incomes benefit most from the lack of taxes on income from capital.

The Desirability of Comprehensive Rather Than Partial Reform

For the above reasons, a continuation of the process of removing exemptions is desirable.

Past experience demonstrates that a selective or partial approach to removing exemptions is unlikely to be effective. In 1973, New Zealand attempted to bring many forms of land transactions within the tax net. However, people have been able to avoid paying this tax. Because share sales are not comprehensively taxed, people have set up companies to own land. They then sell the shares in the company rather than the land itself, thus turning assessable income into tax-free income.

In 1982, attempts were made to overcome this by restricting the ability of people to deduct interest on money borrowed to make tax-free income. But people have still been able to get around the restrictions by using companies to make investments. The only way to overcome the problem is to comprehensively tax income.

Compliance Costs of the Reforms

An extension of the income tax base is likely to raise compliance costs and cause some difficulties in specific areas. This has to be balanced against the improvements in the fairness and efficiency of the tax system which would result. Moreover, existing rules require difficult distinctions to be made between taxed and untaxed income. This creates uncertainty and raises compliance costs. An example is the present uncertainty over whether investment entities are taxed on profits realised on the sale of investments. The appropriate response is to extend the tax base in a manner that does not impose undue compliance costs.

Proposals for Removal of Exemptions

- **General Principle**

It is proposed to remove the existing exemptions for income realised on the sale of assets unless there is some good reason for retaining them. Most forms of income, gains or profits currently treated as exempt income on capital account would be made taxable. In line with the proposals to index the income tax base (outlined later in this Overview), profits or losses on the disposal of assets should be adjusted to exclude income attributable to inflation.

- **Would Gains on Personal Assets be Taxed?**

Personal assets comprise two broad groups:

- appreciating personal assets. This includes personal residences, jewellery, artworks, stamp and coin collections and antiques;
- depreciating personal assets. This includes private cars, refrigerators, washing machines and television sets.

The present tax system encourages more investment in appreciating assets than would be the case under a more neutral system because the proceeds from their sale are exempt from taxation. The continued exemption of income derived on the sale of appreciating personal assets would accentuate this bias, push up the price of existing assets and lead to over-investment in them.

Continuing this exemption would also be inconsistent with the equity objectives of the tax system, since individuals with relatively high levels of income and/or wealth would benefit most. For example, home owners would be advantaged relative to those who rent. Owners of high-priced homes would benefit more than those with low or average-priced homes. Both the efficiency and equity arguments for reform therefore support the inclusion of houses within the regime. Certain other personal assets (such as jewellery, antiques, stamp and coin collections) typically appreciate in real terms and should also be included within the scope of the reforms.

Nevertheless, the historical data indicates that, on average, house prices have in recent years risen only slightly in real (inflation-adjusted) terms. In many cases, the compliance costs for home owners in attempting to measure these small gains would be out of all proportion to the potential revenue involved. Some houses do, however, show large increases in value. Moreover, some people continually purchase and develop houses to sell them at a profit and wealthy people can derive substantial benefits from investing in expensive homes.

In view of these considerations, the Consultative Document proposes that profits on the sale of personal residences, excluding purely inflationary profits, should be assessable. It is proposed that a standard annual allowance set at a level such as \$4,000 should be able to be added to the cost of a house. Any profit on sale would be calculated after inflation adjustment and after taking into account this allowance. The standard allowance would apply only to a person's principal residence, not to additional homes.

This mechanism would ensure that no income tax liability would arise on the sale of most ordinary homes.

A consequential issue is the appropriate treatment of expenditure or losses relating to houses and other appreciating personal property. At present, interest and other expenses relating to personal assets (such as depreciation and expenditure on repairs and maintenance) are not normally deductible on the basis that they represent expenditure or loss of a private or domestic nature. The current treatment of private or domestic expenditure or losses incurred in relation to houses and other appreciating personal assets should be maintained.

Other personal assets (such as cars, household appliances and furniture) typically fall in value because of wear and tear resulting from personal use. If disposals of these assets were included within the income tax system, they would usually generate losses. Making these losses deductible would add to the tax bias in their favour. Including personal assets in the tax system would also increase compliance costs. Accordingly, personal assets which typically depreciate in real terms should continue to be excluded from the tax system.

- **When Would Income be Recognised for Taxation Purposes?**

Under ordinary income tax law, income is sometimes recognised for tax purposes as it accrues (as the income is earned, irrespective of when it is received), but more often people are taxed only on income that is receivable. The accrual method would mean that any increase in the value of assets would be taxable even though the asset had not been sold. This method has economic advantages but in many cases it would be difficult to administer effectively. The present approach of generally recognising income for tax purposes only when assets are sold or otherwise disposed of will therefore be maintained.

Where property is gifted, it is disposed of and so the donor would be taxed on accrued income at that stage. Similarly, when someone dies, a disposal of property would occur. This approach would be consistent with existing law where assets such as financial arrangements are regarded as being disposed of at death. More complex rules would be required where there is a partial disposal of an interest in property, such as may be the case under certain types of leases.

- **The Treatment of Losses on Disposal**

Most countries that tax income on the sale of assets allow some losses to be deducted only when losses are realised and only against income from the sale of other similar assets. This is called "ring-fencing" of losses. In the absence of such rules, people could defer income by not disposing of assets which have increased in value and bring forward losses by disposing of assets which have fallen in value. This would enable people to arrange their affairs to earn income but pay no tax.

The Consultative Document proposes that ring-fencing measures should apply in New Zealand. Losses incurred on the disposal of property should be ring-fenced, except where the property is trading stock of the transferor, depreciable or real property used in a business, or certain intangible property (e.g., patents).

- **Implementation of the New Rules**

The reforms should apply to all disposals of property made after the implementation date, irrespective of whether the property was acquired before or after that date. Income or losses would be measured on the assumption that property was acquired for its estimated market value on the implementation date. Special provisions would apply where valuation proves difficult. This approach would ensure that currently exempt income or gains that accrue before the implementation date would not be taxed.

No implementation date has been proposed, but it would be a date in the future after decisions on the proposals have been made.

IV Adjusting the Income Tax System for Inflation

Existing Income Tax Rules Take No Account of Inflation

The present tax system takes no account of inflation. By taxing the inflationary component of income, an arbitrary wealth tax is currently imposed on saving and investment. This wealth tax is highly variable in its impact. Even at modest rates of inflation, this variability has an adverse impact on the way in which the tax system affects saving and investment.

The Effect of Taxing Inflationary Income

To illustrate the impact of inflation on taxable income, assume that a person invests \$10,000 in a term deposit at a bank at an interest rate of 10%. If the annual interest income of \$1,000 were taxed at 33%, \$670 would remain after tax. If the inflation rate over the year were 5%, the purchasing power of the \$10,000 originally invested would be \$9,500 at the end of the period, since the "real" value of the money would have fallen by the rate of inflation. In effect, \$500 out of the \$1,000 of interest is compensation for the loss of purchasing power of the money invested. The real income is only \$500. The \$330 of tax payable on the nominal interest of \$1,000 therefore represents an effective tax rate of 66% on the real interest of \$500. If real interest only were taxed, the tax payable would be \$165 (33% of \$500) instead of \$330.

Because the present system taxes both the real and the inflationary component of income, higher levels of tax are imposed on real income in times of inflation.

Effective Tax Rates Vary with Inflation

Relative returns on different types of assets are affected differently by inflation when income tax is not adjusted for inflation. Assets that produce income which is fully taxed as it accrues (e.g. interest-bearing deposits) are most affected by inflation. Longer-life assets which produce taxable income only on realisation (e.g., sales of land) are the least affected. This is because the benefit of the accumulation of income free of tax more than compensates for the impact of inflation. Thus, the current tax system is not even-handed when there is inflation, even when the rate of inflation is low.

Proposed Indexation Reforms

The Consultative Document analyses the extent to which the income tax system can be adjusted to take into account the effects of inflation. Indexation of the income tax rules would reduce the revenue incentive for any government to slacken its anti-inflationary stance. This is because, with indexation, the prospect of inflation producing large increases in tax is considerably reduced.

Although there would be considerable benefits in comprehensive indexation of the income tax base, there are some practical issues which would need to be resolved before this could be implemented. The Consultative Document invites submissions on these issues and seeks recommendations on them from the Consultative Committee. Subject to satisfactory resolution of these issues, the various forms of income would be treated as follows.

- Assessable income realised on the disposal of physical assets would be indexed by adjusting both the original cost of the asset and any subsequent capital expenditure for the effects of inflation.
- Depreciation allowances would be adjusted for the effects of inflation by increasing the book value of depreciable assets in line with inflation. The result would be to increase depreciation deductions.
- Income from the sale of trading stock would also be adjusted for inflation. Tax would not be levied on trading income which is merely the effect of inflation. 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 the year.
- Income from selling company shares would be calculated on an inflation-adjusted basis in a similar way to income from the sale of physical assets.
- Both interest income received and interest paid would be indexed. The method of doing so would depend on the nature of the instrument and the type of taxpayer.

V Other Issues

A number of other issues related to the removal of current exemptions and indexation of the tax base would need to be addressed. Anti-avoidance rules would also be necessary. Some changes in the treatment of trading stock and of partnerships are also warranted.

VI Summary of Reforms

Introduction of Indexation

Chapter 10 of Part II of the Consultative Document sets out a range of reforms concerning indexing income from capital for the effects of inflation. In brief, provided that some practical problems can be overcome without undue complexity, Chapter 10 proposes that:

- assessable income realised on the disposal of physical assets should be indexed by inflating the cost of assets for the effects of inflation. The calculation would adjust for the inflation that has occurred in each full quarter since the purchase of an asset;
- income from the sale of trading stock should be adjusted for inflation. Taxpayers would be allowed a deduction which is approximately equal to the average value of stock multiplied by the inflation rate;
- depreciation allowances should be calculated on the basis of the indexed, rather than the historical cost, value of assets;
- interest income and expense should be indexed. This would mean that only the real component of interest income would be assessable. Equally, only the real component of interest expense would be deductible.

Removal of Exemptions

Part IIIB of the Consultative Document sets out the main features of desirable reforms to the tax treatment of income from capital. In brief, Part IIIB proposes that:

- currently exempt income on capital account, including in particular income derived on the disposal of property which is not currently taxable, should become taxable;
- an exemption should continue to apply to depreciable personal assets such as household appliances, furniture, cars and boats. Income or losses derived on the disposal of these forms of asset should remain outside the tax system. This exemption should, however, not apply to income derived on the disposal of appreciating assets (such as antique furniture, vintage cars, works of art, jewellery or collectables such as stamps and coins), subject to appropriate thresholds to minimise compliance and administrative costs;
- income or losses derived on the sale of principal residences should be recognised for tax purposes, after allowing for the effects of inflation, because of the significance of this class of asset in the economy and the need to avoid worsening the present tax bias in favour of investment in expensive houses. This bias has increased the cost of houses relative to what would be the case under a more neutral tax system. Taxpayers would,

however, have the option, with respect to their principal residence, of recording the actual capital expenditure incurred on housing improvements or a standard annual allowance of, say, \$4,000 per annum. The sum of these standard annual allowances, along with the inflation indexation adjustment, would be deductible in the year a the house is sold. This mechanism would ensure that sales of most principal residences do not give rise to a tax liability but sales of more expensive residences may do so;

- expenditure incurred to acquire property and expenditure on capital improvements to the property (except, in the case of principal residences, where a taxpayer elects to deduct the proposed standard annual allowance) would be deductible in the year the property is disposed of;
- interest, maintenance and operating expenditure and losses relating to personal assets should continue to be treated as non-deductible private or domestic expenditure or loss, even where income is recognised on sale. This is appropriate because a large part of the return generated by such assets (i.e., the value of the services they provide to their owners) would remain exempt from tax;
- income derived on the sale of assets owned by a business, whether the assets are tangible or intangible, should be taxable, as should any other forms of currently exempt income on capital account derived by businesses. Such income should be recognised when the property is disposed of;
- there should be no requirement to recognise income on the disposal of property by one company in a specified group of companies to another company in the group as long as the common ownership remains. Similarly, there should be no recognition when property is disposed of by a person to a company which is wholly-owned by the person, or by the company to the person;
- losses derived on the disposal of property should be ring-fenced, except where the property is trading stock of the transferor, depreciable or real property used in a business, or certain intangible property;
- residents should be assessable on all income derived on the disposal of property, irrespective of whether the property is located in New Zealand or elsewhere;
- non-residents should be assessable on New Zealand-sourced income. New Zealand-sourced income would be defined to include income derived on the sale of property which is located in New Zealand and shares in New Zealand resident companies, other than those listed on the New Zealand stock exchange. There would be no change to the way non-residents are taxed on financial arrangements (as that term is defined in section 64B of the Income Tax Act);

- the reforms should apply to all disposals of property made after the implementation date, irrespective of whether the property was acquired before or after that date. Income or loss should, however, be measured relative to the estimated market value of the property on the implementation date so that currently exempt income or gains that accrue before the implementation date would not be taxed. Where property is difficult to value, special provisions would apply;
- a number of types of transactions or events, other than arm's-length sales, are in substance changes in ownership and should therefore be treated as disposals for income tax purposes. For example, leases akin to specified leases and hire purchase arrangements should be treated as taxable disposals;
- transfers of assets between parties to a matrimonial property agreement are not disposals and would not give rise to the recognition of income or loss;
- involuntary disposals, such as the accidental destruction of property, should generally be treated as disposals for tax purposes;
- in accordance with existing income tax provisions, transfers of property on the death of the owner would generally be treated as a taxable disposal. To support this requirement, gifts would also be treated as disposals;
- there should be a deemed realisation of property on emigration by New Zealand residents, except where the property remains in New Zealand, or where a New Zealand-resident trustee is appointed to hold the property. Similarly, persons immigrating to New Zealand would be deemed to acquire the property they own at the date they become resident for tax purposes at its market value at that date;

Other Reforms

- The definition of trading stock should be amended to include land owned by a developer or other person who acquires land for its subsequent sale;
- the valuation rules for trading stock need to be amended to require taxpayers to apply the same valuation method for similar lines of stock. A change in method would be permitted only where the taxpayer notifies the Commissioner of Inland Revenue in advance;
- partnerships should be treated as a separate entity for tax purposes. This would mean that a partnership would be deemed to acquire or dispose of partnership assets and that the entry of a new partner or the departure of an existing one would not trigger a disposition of all the partnership assets;

- sections 129 and 188A of the Income Tax Act, the sections enacted by the previous government in an attempt to reduce avoidance problems which arose with the immediate deductibility of farming and horticultural development expenditure and the exemption of profits on the sale of land, should be repealed.

VII What Impact Would These Reforms Have?

Overall Impact

The reforms would represent a substantial improvement in the tax system. In particular, they would reduce the negative impact of the existing tax system on saving and investment and make the tax system fairer.

Saving and Investment

Any tax on income from capital discourages saving and investment by reducing the net returns to savers and investors. However, the exemptions in our current tax system exacerbate these negative effects by discouraging productive investment in favour of investment in activities that are exempt from tax.

Removal of the exemptions would produce a more uniform tax treatment of different activities. Indexation would reduce the extent to which different activities are subject to different effective tax rates. Removal of the exemptions would broaden the base from which revenue is derived, but the revenue effect of that would be more or less offset by the removal of tax on the inflationary component of income. Thus, no extra tax would be collected from saving and investment, but it would be collected in a more uniform manner.

In summary, the proposed reforms would enhance the quality of investment decisions by reducing the extent to which they are influenced by tax considerations. The result would be a more beneficial pattern of investment.

Specific measures reducing the negative impact of the existing tax system on saving and investment are:

- **Indexation of the Tax Base**

Subject to the resolution of some important compliance issues, indexation would apply to income from all types of assets, thereby enhancing the neutrality of the tax system with respect to investment. The quality of investment decisions would be enhanced since the impact of tax considerations relative to the influence of market returns would be reduced.

If the compliance issues could not be satisfactorily resolved, indexation may need to be limited to physical assets. While this is not as desirable as full indexation, it is preferable to no indexation.

- **The Removal of Exemptions**

The reforms would reduce the taxation incentive to invest in housing, land, buildings and other assets that produce untaxed income on sale. This would reduce or remove some of the present arbitrary and artificial distinctions and increase the relative attractiveness of activities that generate taxable income, such as manufacturing, processing and retailing.

A Fairer Tax System

The reforms would make the tax system fairer.

- **Indexation of the Tax Base**

The removal of the arbitrary wealth tax, imposed by an income tax which taxes both the real component and the inflation component of income would make the tax system fairer for all taxpayers.

- **Removal of Exemptions**

The main direct beneficiaries of the current exemptions are higher-income groups because they have the resources to take advantage of them. This makes the present tax system unfair. The perception that it is unfair is likely to affect the compliance attitudes of taxpayers who are subject to full tax on their income.

Compliance and Administrative Costs

While the reforms are designed to keep compliance costs as low as possible, some increase is inevitable. This must be balanced the advantages of the reforms.

- **Indexation of the Tax Base**

The indexation of depreciation and assets which produce assessable income on disposal would be relatively straightforward for business taxpayers (who are already required to keep detailed records). Indexation of trading stock and financial arrangements would be more difficult. In addition, some additional record-keeping responsibilities would be imposed on non-business taxpayers.

- **Removal of Exemptions**

The present system already involves considerable costs because the distinction between taxed and untaxed income is difficult to administer. In particular, much depends on finding out a taxpayer's intention, as deduced from his or her behaviour. The removal of this distinction would create more certainty, although compliance costs would increase with the removal of exemptions in those instances where currently untaxed income would have to be returned for assessment.

Inflation Policy

The reforms proposed would considerably reduce the extent to which inflation automatically increases the Government's tax take. Indexation is therefore an insurance policy for taxpayers against any future inflationary policies pursued by this or any other government.

Revenue Impact

The reforms would expand the tax base and increase tax revenue by making previously untaxed income taxable. On the other hand, indexation would reduce tax revenue by reducing effective tax rates on income from capital. Overall, it is estimated that the combination of reforms outlined in the Consultative Document would be approximately revenue neutral.

Submissions

People who want to make submissions are encouraged to refer to a copy of the main Consultative Document. Submissions should be lodged by 31 May 1990 with:

The Chairman
Consultative Committee on the Reform
of the Taxation of Income from Capital
c/- The Treasury
PO Box 3724
WELLINGTON

All submissions received by the due date will be acknowledged.

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