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

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**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 Caygill  
Minister of Finance  
19 December 1989

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# CHAPTER 1: INTRODUCTION

## 1.1 Purpose of the Consultative Document

The Minister of Finance, the Hon David Caygill, announced in the Budget of 27 July 1989 that the Government would publish a document this year on the reform of the taxation of capital gains.

This document, while addressing the taxation of capital gains, has a wider focus. It aims to set out an analysis of the present tax treatment of income from capital (also referred to in this Document as capital income), the problems with the present tax system, the directions for future reform and some specific reform proposals. Interested parties will have an opportunity to consider the proposals and to submit their views and suggestions before final decisions are made.

## 1.2 Reasons for the Measures

This review of the taxation of income from capital is part of a major upgrading of New Zealand's income tax regime. The review aims to reinforce the Government's drive to create a fairer and more efficient tax system. It seeks to ensure that all residents of New Zealand pay their fair share of tax.

The reforms will also stimulate efficient investment in New Zealand. In this way, they will contribute to a better use of resources and have a positive influence on saving, investment and the creation of more productive and permanent jobs for New Zealanders.

The reforms are designed to:

- expand the income tax base by removing the exemption for some types of currently untaxed income;
- improve the neutrality of the income tax system by reducing the distorting effects of inflation; and
- improve the equity of the tax system.

## 1.3 Consultative Committee

The Government invites the public to make submissions on the matters set out in this document. A Consultative Committee has been appointed to receive and consider submissions and to advise the Government on the design and implementation of the reforms.

The Committee comprises:

- Mr Arthur Valabh (Chairman), a tax partner and partner in charge of Deloitte Haskins and Sells, Auckland;
- Dr Robin Congreve, a company director, Auckland;
- Mr Rob McLeod, the partner in charge of the tax division, Arthur Andersen and Company, Auckland;
- Mr Lindsay McKay, a solicitor with Chapman Tripp Sheffield Young, Wellington;
- Mr Tim Robinson, an economist with Jarden Morgan NZ Limited, Wellington.

#### **1.4 Terms of Reference**

The Committee's terms of reference are:

- to receive and hear public submissions on matters concerning the design and implementation of the reforms outlined in this Consultative Document;
- having regard to the Government's firm objective of reforming the taxation of income from capital to improve further both the fairness and efficiency of the tax system, to report to the Minister of Finance on:
  - matters covered in this Document, or raised in submissions, concerning the reform of the taxation of income from capital;
  - whether the measures outlined in this Document effectively meet the Government's objective; and
  - any amendments to the measures which the Committee considers necessary for their efficient implementation and operation; and
- to prepare draft legislation to give effect to the Government's decisions on the Committee's recommendations.

The Committee is to report to the Minister of Finance by 1 December 1990.

## 1.5 Submissions

Submissions should contain a brief summary of their main points and recommendations. They should be typed in double space and 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

Submissions received by the due date will be acknowledged.

## 1.6 Attributes of a Good Tax Regime

The fundamental purpose of any tax regime is to raise revenue to finance publicly-provided services and meet the Government's commitments. The level of revenue required is dictated by the level of government expenditure and the size of the budget deficit that the Government is prepared to accept. Any particular tax regime must be evaluated, first of all, in the light of how well it meets the revenue requirement.

However, taxes also create differences between prices paid and received for goods and services and between the costs of and incomes to factors of production. As a result, the tax system can alter relative prices and, in turn, alter the allocation of national resources. In that way, taxes reduce total welfare. It follows that a second important objective of any taxation system should be to raise the required revenue in a way which minimises costs imposed on the country by changes to relative prices.

The tax system is frequently also used to pursue particular equity and other policy objectives. A tax system should accord with society's notions of fairness, but specific policy objectives should be pursued through tax measures only if that is clearly the most efficient means of achieving them.

These general objectives give rise to the following criteria for the evaluation of tax reforms:

- neutrality or economic efficiency;
- ease of administration and compliance;
- fairness or equity; and
- international compatibility.

These criteria will sometimes conflict, resulting in compromises in the design of tax systems. In addition, transitional arrangements may be desirable in relation to reforms which involve significant structural changes.

### 1.6.1 Neutrality and Economic Efficiency

Any tax system which raises revenue will obviously have an effect on the incomes of those who bear the burden of the tax. This "income effect" is unavoidable and is distinguished from the "substitution effect" of taxes. A substitution effect occurs when different rates of tax are levied on alternative activities resulting in excess activity in the lightly-taxed area and too little activity in the highly-taxed area. It is generally preferable that alternative goods or activities be taxed at the same rates so that individuals can freely choose how to act without artificial influence from the tax system.

This is important for economic efficiency because it means that activities which have the highest return to the nation as a whole (i.e., those with the highest pre-tax rate of return) also have the highest private rate of return (i.e., post-tax rate of return to the investor). More precisely, an income tax which is neutral with respect to investment is one in which the effective tax rate on all forms of investment is the same. Thus, it would be desirable to maximise the extent to which the tax system is neutral between different forms of income from capital.

All forms of income are produced by some form of capital. Throughout their lifetimes, individuals acquire a wide range of skills and knowledge for which they receive a return. The return may be in the form of wages or salary or other forms of income. The skills and knowledge so acquired constitute a form of capital - human capital. A business employs plant and machinery (physical capital), staff (human capital) and various forms of intangible assets (such as reputation and brand name) to generate business income.

Such income may be in a monetary or non-monetary form. It may be derived in the current or a future period. For example, employment-related education or training is generally undertaken because it is expected to generate a higher level of money income in the future. Conversely, non-employment-related education is undertaken because it generates non-monetary or "psychic" income (i.e., additional satisfaction as a result of an enhanced knowledge of or ability to enjoy a particular subject). In either case, an investment in education or training is an investment in human capital - the capacity to produce income, monetary or non-monetary - in the future.

Similarly, when a business spends money on staff training, it is investing in human capital. When it spends money on advertising or marketing, it is investing in its reputation or brand name. In either case, the return on the additional expenditure is expected to be a higher level of profits in the future.

This higher level of future profits manifests itself in the current period as an increase in the current value of the business (corresponding to its increased stock of physical, human, reputation or brand name capital).

A neutral income tax system would treat each type of expenditure and the income it produces in such a way that the proportion of the pre-tax income paid in tax is the same for all investments.

The effective tax rate on an investment can be defined as the difference between the pre- and post-tax rates of return on the investment expressed as a percentage of the pre-tax rate of return. In symbols, the effective tax rate on an investment is the rate  $e$  such that:

$$\begin{aligned} e &= (R-r)/R \\ &= 1-r/R \end{aligned}$$

where

$$\begin{aligned} R &= \text{the pre-tax rate of return on the investment; and} \\ r &= \text{the post-tax rate of return on the investment.} \end{aligned}$$

Effective tax rates can be defined equivalently in terms of pre- and post-tax net present values ("NPVs"). For most purposes, it does not matter whether a rate of return or a NPV definition is used, so long as one or the other is used consistently.

In summary, economic welfare is normally enhanced by a neutral tax system. A neutral income tax system would require all forms of income - whether in monetary or non-monetary form and whether realised in the current period or realisable in the future, and hence showing up in the current period as a change in the value of the corresponding asset - to be taxed uniformly.

### 1.6.2 Ease of Administration and Compliance

The costs to the Government of administering the tax system and to taxpayers of complying with it are economic losses to the community as a whole. A good tax system will minimise such losses. This is most readily achieved by a tax system which for most taxpayers is as simple as possible. The economic efficiency of a tax system is enhanced if the participants in a transaction are able to determine in advance, and with certainty, the tax liability created by that transaction. Perhaps the most common request made by the private sector is for the tax system to be made simpler and more certain and that costs incurred by honest taxpayers in complying with taxation rules be reduced.

The most frequently made criticism of post-1984 taxation reform is the complaint that the tax system has become more, not less, complex and that compliance costs have risen. This view overlooks the problems which have had to be addressed and the achievements which have been made. For example, a complicated system of sales taxes has been replaced with the far simpler Goods and Services Tax. New Zealand's tax system is certainly no more complicated - and indeed in some respects, it is much simpler - than the tax systems of most comparable countries.

For the average wage and salary earner, income tax requirements have been made simpler. There are fewer special deductions (with offsetting lower tax rates) and tax on interest and dividends is now collected, to a large extent, through withholding taxes rather than through terminal tax. Inland Revenue Department procedures have also been upgraded to provide a better and speedier service.

For business taxpayers, the tax system has become more complicated, but this is unavoidable. An income tax system with complex and varying concessions and exemptions has been replaced with a system which is more uniform in the manner in which it taxes different forms of income. On the other hand, added complexity has been introduced by the imputation, accruals and international tax regimes.

The imputation regime is designed to minimise tax penalties imposed on corporate investment. The accrual and international tax reforms have limited impact on most taxpayers. Where they do apply, they do involve additional complexity. Nevertheless, such complexity is necessary to maintain the revenue base and the fairness and efficiency of the tax system.

It has been commented that the pre-1984 legislation had:

"not kept abreast with the sophistication or aggressiveness of the business and particularly the corporate tax communities in what we would euphemistically call 'tax management' practices ... the provisions of the legislation ... represented an open invitation to those inclined to do so to minimise taxation liabilities if not virtually at will, then at least without substantial difficulty."

(L McKay, "The Changed Taxation Playing Fields", 1989).

The tax system must be sufficiently developed to meet the growing sophistication of those taxpayers who can take advantage, and have in the past taken advantage, of any gaps in the tax legislation. The additional compliance costs faced by businesses should be weighed against these factors and the lower tax rates which have been made possible, despite an increasing taxation revenue requirement. Reductions in the level of existing compliance costs should, however, be possible. To that end, the Government has appointed the Taxation Simplification Consultative Committee.



To some extent, reforms to the taxation of income from capital can reduce the complexity of the existing tax system by removing arbitrary distinctions between taxed and untaxed income. In other respects, such reform would increase complexity. As in the past, a balance must be drawn between what is required to achieve a neutral tax system and the size of the additional administrative and compliance costs that a more neutral tax system would impose.

For example, it would be difficult to measure the accrued increase in a person's human capital as a result of education. Similarly, it would be difficult to measure, on an accrual basis, changes in the value of a firm's brand names or reputation. Conversely, it is relatively easy to measure the increase in income resulting from an expansion of current output. This latter form of income is assessable as it accrues, while the return on capital in the first two cases is taxable only on realisation, if at all. Thus, the income tax system, like accounting practice, tends to discriminate between different forms of income according to the ease with which they can be quantified. In some cases, this may be desirable since resources devoted to administering and complying with the tax system are pure waste from society's point of view.

The end result of a tax system is to transfer income from taxpayers to the Government without achieving any increase in society's welfare. Hence, at some point, the gains attributable to a more neutral tax system will be offset by the losses arising from higher administrative and compliance costs. A primary objective of the reform of capital income taxation is to find the appropriate balance between the neutrality objective and the objective of minimising administrative and compliance costs.

### **1.6.3 Fairness**

The exemption or concessional treatment of any form of income is often perceived to be inequitable. In many cases, on closer examination, the rationale for such concern is less obvious. In a market economy such as New Zealand's, differences in tax treatments are often capitalised into asset prices so that the expected rate of return, adjusted for risk, on all assets tends towards equality. A person who appears to be receiving a taxation advantage may not in fact be receiving one. In many cases, the person has paid for the concession by paying an increased price for the asset to which the tax advantage is attached.

Nevertheless, fairness is important. Whenever the tax system changes, asset prices are likely to change, thereby creating losses or gains to the holders of such assets. Secondly, imperfections in the market mean that not all taxation advantages will necessarily be fully capitalised into asset prices. Finally, even if inequities were illusory, a perception of unfairness in the tax system can undermine its integrity and operation.

The capitalisation of taxation advantages into asset prices can best be described by way of an example. Suppose that the Government unexpectedly announced that interest on local authority stock is to be exempt from tax. (The Government has, of course, no intention of making such an announcement.) Would stock prices remain unchanged? Clearly they would not - they would rapidly rise and the yield would drop to a level which would be very similar and perhaps identical to the pre-announcement post-tax level. Would the exemption then be unfair or inequitable? Investors in local authority stock would earn no more after tax than they would on other investments (after adjusting for risk). Though they may appear to obtain a tax advantage, there would be none in reality.

A tax change such as this would, however, have transitional effects. In particular, holders of local authority stock at the time of the announcement would receive an unexpected gain since the value of their stock would rise. The announcement of other types of tax changes might produce unexpected losses for some taxpayers. Hence, in considering the equity consequences of the present tax system and proposed changes, it is necessary to consider both longer-term and transitional impacts.

As noted above, even if it were accepted that taxation advantages are capitalised into asset prices in the manner suggested above, the taxation system should be seen to be fair. The income tax system is heavily reliant on a high degree of voluntary compliance by taxpayers. If taxpayers believe that, because some forms of income are exempt, they are bearing an unfair proportion of the total tax burden and the tax system overall is unfair, resistance to taxation can be expected to increase. Co-operation with the Inland Revenue Department will decline and a system based on voluntary compliance will become less efficient and less feasible. This will in turn result in a tax system with higher administrative and compliance costs which, as noted above, represent a waste of society's resources.

Thus, fairness is important to taxation reform. The only form of taxation which is efficient in the longer term is one which is seen to be fair. Achieving a tax system which is seen to be fair should therefore always be a prime objective of taxation reform.

#### **1.6.4 International Compatibility**

In addition to evaluating whether a tax system would be sensible if applied to New Zealand in isolation from the rest of the world, any evaluation should examine its international compatibility. Reform options which may be desirable when viewed from a purely domestic context may be impractical or undesirable when the inter-reaction with overseas taxation regimes is considered. The tax system may, for example, provide unintentional incentives to transfer capital from one country to another. Reform options might also require renegotiation of double tax agreements with other countries.

## **1.7 Objectives and Scope of this Review**

The objective of this review is to consider the manner in which income from capital is currently taxed, identify defects in that system when compared with the attributes of a good tax system outlined above and to consider how the tax system could be reformed so that it better meets the criteria for a good tax system.

The review is limited to income from capital (also referred to as capital income). Income from capital is income derived from holding and disposing of assets and liabilities. This definition excludes most forms of labour income with only minor exceptions (e.g. income from restrictive covenants). More specifically, the review considers the remaining tax exemptions for forms of capital income, how the tax system could be adjusted for the effects of inflation and certain related areas concerning the taxation of trading stock and depreciation rules.

## **1.8 Outline of the Document**

Part I of this document (Chapters 2-3) outlines the current rules applying to income from capital. It identifies where those rules fail to meet the requirements of a good tax system. The main defects are seen as being the exemption of certain forms of capital income (income on capital account and non-market income) and the failure of the tax system to take into account the effects of inflation. The adverse consequences flowing from those defects are considered.

Parts II (Chapters 4-10) and III (Chapters 11-15) outline reforms which would index the tax system for inflation and remove exemptions for income on capital account in a manner which should improve the income tax system. Part IV (Chapters 16-17) considers related issues including how such measures could be integrated into the existing Income Tax Act and a desirable transitional approach.

Part V (Chapter 18) concludes by summarising the desirable reforms and their economic effects. A number of appendices cover in more detail some of the aspects considered in the chapters of the Document.



# **PART I: THE PRESENT TAX REGIME**



# CHAPTER 2: CURRENT TAX TREATMENT OF INCOME FROM CAPITAL

## 2.1 Introduction

This chapter outlines the existing income tax rules that apply to income from capital. Section 2.2 provides an overview of current income tax law in this area highlighting the extent to which those rules diverge from the reality of what constitutes income. Two of the more important areas of divergence are the general failure of current law to recognise the impact of inflation on the true position of taxpayers and the judicial development of a distinction between "income on revenue account" (which is taxable) and "income on capital account" (which prima facie is exempt from tax).

The basis and nature of this capital/revenue distinction is examined in section 2.3. It is emphasised that this is a distinction which is not based on considerations that most people would consider important when making investment decisions or when measuring how much they have to spend or save over a period of time. It is also a distinction that the courts have often found difficult to draw. For those reasons, and in order to maintain the integrity of the tax system, the capital/revenue distinction has been considerably modified by statutory provisions over time. Those provisions, which are outlined in section 2.4, are still relatively narrow in scope and leave significant elements of income out of the tax base. That is illustrated by section 2.5, which provides examples of presently untaxed income. Section 2.6 then considers the extent to which income tax rules vary, and the extent to which the rules previously outlined are modified, depending on the entity which derives that income. Finally, section 2.7 offers concluding comments.

## 2.2 Overview

The current tax treatment of income from capital diverges significantly from the treatment which would result from applying a comprehensive and neutral tax regime as described in the previous chapter.

### 2.2.1 The Comprehensive Taxation of Income

Under a comprehensive and neutral income tax in an economy which has no inflation, a person would be taxed on all income which accrues to them over the taxable period. This would include all receipts accruing from holding assets, the proceeds from the sale of assets, and any increase in the market value of an asset over the period even though that gain may not have been, and may eventually never be, realised by way of a sale.

A deduction would be allowed for any capital expenditure or loss. This would include any decrease in the market value of assets held and the costs of acquiring/creating and holding an asset. Where an asset is purchased, the price of the asset would be deductible expenditure but this would be offset by

including as income the market value of the asset. Similarly, where a taxpayer incurs expenditure to create an asset, that expenditure would be deductible but offset by including in income the value of the asset created.

The net result would be that a deduction would be allowed for capital expenditure in the year that expenditure is incurred but only to the extent to which the expenditure is greater than the market value of the asset purchased or created by the expenditure. The owners of assets would be taxed on any increase in the market value of those assets and receive a deduction for any decrease in their market value.

In the presence of inflation, the above calculations of income should be adjusted. Inflation increases the market value of assets held when measured in dollars of the day. However, an increase in the market value of an asset merely because of inflation does not represent an increase in a person's real wealth. An increase in wealth is more appropriately measured as the change in the purchasing power of a person's assets over a period. In other words, a true measure of income requires the income calculated in accordance with the previous paragraph to be adjusted so as to exclude any inflationary elements.

A separate issue is the extent to which any tax system should tax foreigners on income they derive from New Zealand and the extent to which it should tax New Zealanders on income they derive from offshore. Under section 242, of the Income Tax Act 1976, New Zealand adopts a standard international approach of taxing all income sourced in this country (source being determined by sections 243 to 245), whether derived by a resident or a non-resident, and all income derived by New Zealand residents (residence being determined by section 241) even if that income is sourced outside New Zealand. These rules are subject to the provisions of various double tax treaties New Zealand has entered into.

### **2.2.2 True Income and Taxable Income Compared**

For a variety of historical and administrative reasons, the current tax system does not measure income on a comprehensive basis. To some extent this is because, as noted in Chapter 1, some forms of economic income are very difficult to measure, and thus, to tax in an appropriate way. In other words, it is recognised that taxation of all forms of income as it accrues is impracticable. While governments can attempt to make income tax systems more comprehensive and neutral to improve the operation of the tax system, there is a limit beyond which this is unfeasible, or beyond which excessive compliance and administrative costs would be incurred.

Departures from a comprehensive and neutral base are not always the result such practical requirements. Many departures have no rationale other than historical precedent - that, in the past, such forms of income have not been



subject to tax. Many types of income from capital seem to fall within this category.

When income tax was first introduced, it was left to the courts to define what was meant by income. In the absence of statutory guidance, the judiciary turned to trust law and other precedents for an income definition. As a result, certain kinds of income, especially most increases in the value of assets other than trading stock, were excluded from the tax base. These excluded types of income fall under the general heading of "income on capital account".

The 1988 Royal Commission on Social Policy<sup>1</sup> commented that:

"... in the administration of the New Zealand tax system we have followed trust law concepts. They differentiate the interests of the life tenant (entitled to income) from the interests of the remainderman (entitled to capital and so to the realisation of capital assets of the trust). . . . With hindsight it seems surprising that concepts of trust law were considered an appropriate substitute for a direct focus on economic efficiency and equity concerns in the raising of taxes."

In a similar vein, Professor R Parsons has stated:<sup>2</sup>

"A principle of trust law that would direct that in the circumstances an item should be allocated to the remainderman, because this was the presumed intention of the creator of the trust, seems a strange basis for a conclusion that the item is not one in which the State should share through a tax."

New Zealand's income tax legislation continues to leave the term "income" undefined. Section 38 of the Act levies tax on all "income" derived by every person. Assessable income is defined in both section 2 and section 65(2) of the Act. However, neither attempts to advance a comprehensive definition of the term "income". Section 2 defines "assessable income" as "income of any kind" which is not specifically exempted by the Act. Section 65(2) provides a list of items which are to be included within the ambit of the term, but concludes by encompassing "income derived from any other source whatsoever".

To a significant extent, therefore, vague statutory wording has required the judiciary to determine what constitutes "income" for tax purposes. In doing so, it has tended to favour "everyday usage" or "ordinary concepts" over more fundamental principles. That has often lead to definitions of income which, on

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<sup>1</sup> April Report, Volume III, Part Two, page 450

<sup>2</sup> Australian Tax Forum 3:3 1986

close scrutiny, contribute little to the interpretative problem. For example, in Lambe v IR Commrs<sup>3</sup> it was observed that income is "what in one form or another goes into a man's pocket".

One of the better summaries of what constitutes income for common law purposes is to be found in Reid v CIR.<sup>4</sup> The primary indicia are:

- income is what comes in;
- income is usually evidenced by periodicity, recurrence and regularity; and
- the status of income will be in part dependent on the nature of a receipt in the hands of the particular recipient.

These characteristics of income do not take into account the extent to which a particular receipt is income in terms of adding to an individual's wealth. This has produced a concept of income that is somewhat esoteric and unrelated to the way that people typically view receipts. For example, if a person becomes wealthier as a result of receiving a sum of money, it matters little to them whether that money is received as a lump sum or as a series of payments over time, provided the present value of the payments are the same. Nevertheless, such a distinction can have important taxation consequences, with the former being more likely to be outside the judicial interpretation of income than the latter.

Since courts follow their past decisions, the only way in which income for income tax purposes can be brought more into line with the real position of taxpayers is for this to be done by specific legislation. This the legislature has done since the beginnings of income taxation. Over time, the income tax system has, by specific legislation, been brought more and more into line with the actual position of individual taxpayers.

Nevertheless the definition of income is still significantly determined by historical criteria. The result is that some forms of income are untaxed and sometimes people are taxed on income which in economic terms they do not derive. Depending upon the circumstances and the nature of the income, therefore, the Income Tax Act may over- or under-estimate the level of a person's income.

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<sup>3</sup> (1933) 18 T.C. 212

<sup>4</sup> (1983) 6 NZTC 61,624

### 2.2.3 Inflation and Current Income Tax Rules

In general, our current income tax rules are based on historical cost accounting concepts that make no allowance for any change in purchasing power brought about by inflation. As stated in Lowe v. Commissioner of Inland Revenue:<sup>5</sup>

"in this country accounts for financial reporting purposes have traditionally been prepared according to historical cost conventions and tax accounting has followed that practice subject to modifications required under the income tax legislation."

The provisions of the Income Tax Act, therefore, "assume the use of nominal dollars and the disregarding of any changes in the value of the dollar over time."

The result is that taxpayers can be overtaxed on capital income they derive relative to the position under an income tax which does provide an inflationary adjustment. A simple example is the interest derived by a lender of funds. If the inflation rate is 10 per cent per annum and the interest rate is 10 per cent per annum, then the lender has made no real income after allowing for inflation. However, under our income tax rules, the lender would be taxed on all of the interest despite the fact that it is merely compensation for the effects of inflation. In that way, lenders are being taxed on income which in reality they do not receive.

The converse is that people who borrow funds for a business use are not being taxed on their full income. Just as the lender's wealth position in the above example in inflation-adjusted terms remains the same before taxation, so does the borrower's wealth position. Nevertheless, current tax rules will generally allow the borrower a deduction for interest costs. In other words, the borrower is receiving a net deduction for a transaction which leaves its economic position in inflation-adjusted terms unchanged.

The lack of recognition of inflation in general income tax rules therefore marks a significant departure from the taxation of true income.

### 2.2.4 The Rules on the Deductibility of Business Expenditure

The current income tax rule on the deductibility of business expenditure is that expenditure on revenue account is deductible, whereas other expenditure (expenditure on capital account) is non-deductible. The critical issue then becomes whether the expenditure is on revenue or capital account.

Current rules can also broadly be interpreted as drawing a distinction between three forms of expenditure:

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<sup>5</sup> (1981) 5 NZTC 61,006 at 61,028-29

- expenditure which does not create or improve an identifiable capital asset;
- expenditure on depreciable assets; and
- expenditure on non-depreciable assets.

Of these three forms of capital expenditure, the first is expenditure on revenue account and is deductible as incurred. Expenditure on depreciable assets can be viewed as deductible over the life of the asset, whereas expenditure on non-depreciable assets is non-deductible.

Expenditure that is seen as not creating or leading to the acquisition of an identifiable capital asset is deductible in full in the year in which the expenditure is incurred. An identifiable capital asset is a recognisable asset that will continue to produce assessable income in years after the year in which the expenditure on that asset was originally incurred. Thus, the costs of repairing and maintaining an existing business asset are generally deductible in full in the year those costs are incurred. This position is, however, subject to section 104A of the Act, which, in effect, prevents a deduction for most goods or services until and unless the goods are used in the production of assessable income or the services are performed.

Where expenditure is seen as being directly related to the production or purchase of an identifiable asset, the expenditure is not deductible in the year incurred. Instead expenditure to create or acquire fixed assets (plant, machinery, equipment or premises) used in the production of assessable income can generally be amortised or accrued over the expected economic life of the asset by way of a depreciation allowance. Over- or under-deductions of the initial expenditure can then be recovered in the year the asset is disposed of, or is no longer used in the production of assessable income. Depreciation is considered in more detail in Annex 2.1.

On the other hand, where the expenditure relates to the creation or acquisition of non-depreciable assets, no deduction is provided for. For example, professional and other fees incurred in raising equity capital are non-deductible. The expenditure relates to an identifiable asset - the corporate equity - but that is not a fixed asset and therefore no depreciation allowance is available.

Business expenditure, therefore, can be:

- deductible in the year incurred - where no identifiable capital asset is produced or acquired; or
- deductible over the life of the asset - where a fixed asset is produced or acquired; or

- non-deductible - where the expenditure relates to the production or acquisition of a non-depreciable asset.

## 2.2.5 The Deductibility of Anticipated Expenditure or Losses

### General Rule

Existing rules do not require cash payments to be made before expenditure can be considered to be incurred and therefore deductible, but generally existing rules require a high level of certainty that such payments will be made. In broad terms, ordinary rules require the taxpayer to be committed to the expenditure before a deduction is allowed. Thus, normally no deduction is allowed for uncertain expenses such as those represented by reserves. For example, no deduction is allowed for money set aside to meet trade debts which are unlikely to be repaid. Bad debts must actually be written off as irrecoverable before a deduction is allowed, although even that constitutes a relatively lenient approach since a loss from a bad debt is not certain until the borrower is officially relieved of the obligation to repay through, say, bankruptcy.

In line with the policy of not allowing deductions for expenditure until the expenditure has fallen upon the taxpayer (so that anticipated expenditure is non-deductible), current rules normally take no account of any fall in the market value of assets which are held and not sold or disposed of. Thus, even where a decline in the value of an asset is deductible, the broad rule (which is subject to the exceptions noted below) is that no deduction is allowed until the loss is realised by way of sale or disposal.

### Exceptions

The general approach outlined above is subject to a number of significant exceptions. Depreciation allowances are one such exception. In an economic sense, depreciation allowances are a deduction for the fall in the value of an asset as a result of physical wear and tear or economic obsolescence.

The tax treatment of trading stock is another exception to the general rule against anticipating losses. Under the trading stock regime, the cost of purchasing goods is deductible at the time of purchase but the value of the goods is added back into assessable income. The difference between the value of the goods and their sale price is then recognised as income at the time of sale. However, trading stock held can be valued, at the option of the taxpayer, at cost price, market selling value, or replacement price. Since any fall in the book value of trading stock results in a deduction from assessable income, the rules for the valuation of trading stock enable taxpayers to value their inventory at market value and thus anticipate unrealised losses where market value is lower than cost price. The trading stock rules are considered in more detail in Annex 2.2.

A third method of deducting anticipated capital expenditure or losses is provided under the accrual rules. Very broadly, the accrual rules allow expected capital expenditure on a "financial arrangement" to be recognised over the term of the arrangement on a yield to maturity basis. Taxpayers holding financial arrangements as part of their business activities also may have the option of recognising as expenditure any fall in the market value of the arrangements.

It can therefore be seen that there are a number of significant exceptions to the rule that expenditure cannot be deducted if it is merely anticipated and has not actually fallen upon the taxpayer. To some extent, this may reflect the impact of accounting principles, which require financial reports to present a prudent picture of the financial position of an enterprise.

## **2.2.6 The Rules on the Assessability of Income From Capital**

Income from capital may also be said to fall into one of three categories:

- ordinary income, that is taxable as income under ordinary concepts as interpreted over the years by judges;
- income derived from holding or disposing of an identifiable asset, other than in the course of business. Such income (income on capital account) has traditionally not been subject to income tax; and
- income on capital account which would not be taxable as income under ordinary concepts but which has been made assessable by explicit provisions of the Income Tax Act.

The distinction drawn between ordinary income from capital and income that has not traditionally been subject to income tax is considered in section 2.3 below.

With respect to the third category of income, the following list consists of forms of income which traditionally may not have been considered to be taxable but which have been made taxable under specific provisions of the Income Tax Act:

- gains from the sale of personal property and from undertakings and schemes where the income falls within the ambit of section 65(2)(e);
- gains from investments in Foreign Investment Funds ("FIFs") under section 65(2)(eb);
- various gains from land transactions under section 65(2)(f);
- otherwise non-taxable payments under leases taxable under section 65(2)(g);

- certain otherwise non-taxable income from land made taxable by section 74;
- some receipts in what would otherwise be a non-taxable form which are included in assessable income under section 65(2)(h) by virtue of the definition of royalty in section 2 of the Act; and
- gains from financial arrangements under section 65(2)(jb).

### 2.2.7 Timing of Income Recognition

Just as there is a general rule that expenditure is not deductible until it has been incurred, so there is a general rule that income is not assessable until it has been derived. The requirement that income should be derived before it becomes assessable has been interpreted as meaning that income is not assessable until it has "come home to the taxpayer in a realised or immediately realisable form".<sup>6</sup>

The mirror image of the general rule that anticipated expenditure cannot be deducted (so that losses on holding or disposing of assets are non-deductible until those losses are realised) is a similar rule that anticipated income from holding or disposing of an asset is not taxed until the income is realised. Thus, as a general rule, a taxpayer who holds an asset producing a taxable gain is not taxed on increases in the market price of assets held. Instead, any tax impost is normally deferred until the asset is disposed of in a way that produces a measurable and certain gain over the purchase price.

The interpretation given to when income is derived tends to require a higher indicia of having "come home" to the taxpayer than the indicia used to determine when expenditure has been incurred. This may reflect accountancy principles, which tend more readily to recognise expenditure than income so as to avoid as far as possible over-stating income in financial statements.

The main exception to the general rule providing for the recognition of anticipated income is the accrual regime in sections 64B to 64M of the Income Tax Act. This provides that expected income from "financial arrangements" is recognised over the term of the arrangement on a yield-to-maturity basis. As already noted, the accrual rules also provide for a method of determining income and expenditure based on the change in the market value of the arrangements. Where that market value approach can be, and is, adopted, it can result in unexpected and unrealised capital income being assessable.

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<sup>6</sup> Carden's case (1938) 63 CLR 108 at 155

## 2.3 The Capital/Revenue Distinction

As noted in the overview, the current tax treatment of capital income and expenditure fails in a number of respects to measure the actual change in the economic position of taxpayers. Sometimes those differences between taxable and actual income are made necessary by practical requirements. In many instances, however, income is not properly measured for tax only purposes because of the previously described approach to the interpretation of the term "income". Central to that approach has been the distinction drawn between ordinary income and expenditure (income and expenditure on revenue account) and other income and expenditure (income and expenditure on capital account). The former have been recognised for income tax purposes, while the latter have not been recognised.

The capital/revenue distinction which the courts have drawn is considered in more detail in Annex 2.3. As shown in that annex, to a large extent the capital/revenue distinction on which the current income tax system is founded is the product of a long history of judicial interpretations of a wide range of factual circumstances. In making the distinction, courts will frequently refer to what "common sense" dictates. However, this "common sense" is not founded on any basis which necessarily reflects the reality of the taxpayer's economic position or circumstances.

Nor is the distinction an easy one to draw in many cases. Although it is clear in most everyday transactions whether a particular receipt or item of expenditure should be on revenue or capital account, there are many occasions when that is not the case. Thus judges often stress the "fineness" of the distinctions they are called upon to make and the difficulty that involves.

This is illustrated by BP Australia Limited v FCT<sup>7</sup> where the first court to consider the issue found the taxpayer's payments to be non-deductible, the Full Court of the High Court of Australia was divided 3 to 2 against the taxpayer, and the Privy Council eventually found for the taxpayer. The Privy Council stressed the difficult job the courts have in such cases, quoting<sup>8</sup> an observation made in an earlier case<sup>9</sup> that:

"the functions of business are capable of complexity and the line of demarcation [between items on revenue account and items on capital account] is sometimes difficult to draw and leads to distinctions of some subtlety between profit that is made 'out of' assets and profit that is made 'upon' assets or 'with' assets."

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<sup>7</sup> (1964) AC 244

<sup>8</sup> at page 262

<sup>9</sup> CT v Nchanga Consolidated Copper Mines Ltd [1964] AC 948 at page 960



The difficulties with drawing this distinction are also evident in the issue of the extent to which the financial institution cases considered in Annex 2.3 should be extended. Some of the cases in that area, in particular, can be difficult to reconcile.

The importance current law places on the capital/revenue distinction was noted in one New Zealand case<sup>10</sup> where it was stated: "The distinction between capital accretions and revenue operations runs all through the law of income tax". The same case noted: "It is not easy to state in plain clear words any infallible test by which this question [whether income is on revenue on capital account] may in all cases be resolved."

On the revenue side, the capital/revenue distinction which has governed so much of the operation of the income tax system lacks a clear rationale that might make it relevant in measuring the true income of taxpayers. On the expenditure side, the distinction does, however, recognise that expenditure producing lasting benefits should not be immediately deductible.

## 2.4 Existing Statutory Provisions Which Modify the Capital/Revenue Distinction

In reaction to a common law interpretation of the Income Tax Act which resulted in significant divergences between income as measured for tax purposes and income in terms of increased wealth, legislatures both here and overseas have, over time, consistently widened the income tax base to reflect reality more closely. This has been done by way of specific provisions being inserted into the Act.

An example is section 65(2)(ja), which was enacted in specific response to Dawson v CIR.<sup>11</sup> In that case, it was held that the free use of a television set in consideration for advancing funds to a finance company was not income. This was because the benefit was not convertible into cash. That was not a satisfactory position since the use of the television set provided the taxpayer with a clear economic benefit. The legislative response was to bring such benefits into the tax net by specific amending legislation.

This process of expanding the common law ambit of the income tax system is particularly notable in the area of the capital/revenue distinction. The distinction has gradually been amended as specific provisions have sought to bring within the term "income" items which would be considered outside the ambit of that term as it has been defined by the courts. The statutory erosion

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<sup>10</sup> CIR v City Motor Services [1969] NZLR 1010 at page 1017

<sup>11</sup> (1978) 3 NZTC 61,252

of the capital/revenue distinction can be traced back to the beginnings of income tax. For example, in the United Kingdom "profits on discounts" of financial instruments were made taxable as early as 1805. In New Zealand, a gain from land acquired for the purpose of deriving a profit on sale became taxable in 1916.

This section considers current provisions which erode the capital/revenue distinction.

## 2.4.1 Gains from the Sale of Personal Property

### (Section 65(2)(e))

Section 65(2)(e) of the Act attempts to bring within the definition of income gains from the sale of property which might otherwise be considered to be non-taxable income on capital account. The first two of three parts or limbs of the section apply only to gains on property other than land.

The first limb of section 65(2)(e) assesses profits or gains derived from the sale of property where the taxpayer is a dealer in such property. It appears that the legislative intent when a similar provision was first enacted (in 1916) was to tax those who were dealers in property of a particular type even if the property on which a profit was made was held by that person for other purposes. However, the courts have interpreted the provision strictly and have included profits only where the specific asset sold was held for dealing.<sup>12</sup> It is thus difficult to contemplate situations where a taxpayer would be assessed under this limb without the gain being taxable under other provisions of the Act. This is because dealing in property is likely to constitute a business and thus gains on property sold are likely to constitute ordinary income.

The second limb of the section includes within a person's assessable income all profits or gains derived from the sale or other disposition of property where the property was acquired for the purpose of selling or otherwise disposing of it. Cases in this area have primarily been concerned with the question of what constitutes a purpose of resale at the date of acquisition. Again the courts have tended to adopt a restrictive interpretation. The taxpayer must evidence a purpose of resale rather than a mere intention. Thus, where property is acquired for a purpose other than resale (for example, purchasing shares so as to control a company) but with the intention of resale, then the section does not apply.<sup>13</sup> Where more than one purpose exists, it is the dominant purpose that is relevant in determining assessability.<sup>14</sup>

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<sup>12</sup> Hazeldine v CIR [1968] NZLR 747

<sup>13</sup> Plimmer v CIR [1958] NZLR 147

<sup>14</sup> CIR v Walker [1963] NZLR 339

The recent Court of Appeal decision in CIR v National Distributions Limited<sup>15</sup> indicates that the ambit of the second limb of section 65(2)(e) might be wider than many commentators had previously considered it to be. For example, the view advanced in an earlier Australian case<sup>16</sup> that property acquired as a hedge against inflation would not be within the ambit of the provision, was explicitly rejected. It was held in National Distributors that provided the dominant purpose for the acquisition was sale, gains are taxable. Nevertheless, it was noted that company shares could be purchased for the purpose of obtaining a dividend stream. In that case the second limb of section 65(2)(e) would not apply. Moreover, shares could be acquired to secure a dividend stream and also growth in the value of the shares. It was stated that if there is no, "clear dominant purpose of resale at the time of purchase, any profits on the ultimate sale of the shares are not within the second limb."

#### **2.4.2 Profit Making Undertakings or Schemes (Section 65(2)(e))**

The third limb of section 65(2)(e) includes within assessable income "all profits or gains derived from the carrying on or carrying out of any undertaking or scheme entered into or devised for the purpose of making a profit". Under this third limb, the property in question is not limited to personal property but also includes land.

The wording of this limb is extremely wide. It could have been interpreted so as to bring within the tax net many transactions otherwise producing non-taxable gains, as long as the transaction constituted an "undertaking or scheme". However, the courts concluded that there was no legislative intent to so widen the tax base. They have interpreted the provision as requiring the profit or gain to be income on revenue account (which would be assessable under other provisions) or at least flowing from a scheme of a business-like nature before it can be taxable under the limb.<sup>17</sup> As this was expressed by the Privy Council,<sup>18</sup> for an undertaking or scheme to fall within the ambit of the provision, it "must be a scheme producing assessable income, not a capital gain". Clearly, such an interpretation leaves the provision with limited actual effect in widening the income tax base.

#### **2.4.3 The Effect of Section 65(2)(e)**

Section 65(2)(e) brings to tax "profits or gains" in the year such "profits or gains" are derived. This has been interpreted as meaning that the "profit or gain" must have been realised by way of sale or other disposal before it can be said to have been derived. In other words, the section does not tax unrealised

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<sup>15</sup> CA 137/87

<sup>16</sup> Gauci v FCT (1975) 135 CLR 81

<sup>17</sup> Eunson v CIR [1963] NZLR 278

<sup>18</sup> McClelland v FCT (1970) 120 CLR 487 at page 495

or accrued gains.

On the other hand, if a taxpayer holds the property as part of a business, the property may constitute trading stock under section 85 of the Act which allows unrealised losses to be deducted. Persons not holding the property as part of a business are not subject to section 85. However, the definitions of trading stock in sections 90, 91 and 197 are wider and would generally include property subject to section 65(2)(e). These sections operate to deem dispositions of trading stock (as widely defined) to be sales at market value. The result is that any transfer of ownership of an asset subject to section 65(2)(e) otherwise than by way of sale gives rise to a tax liability as if the property were transferred by way of sale. It therefore seems to cover gifts of property and transfers resulting from death.

A limitation on section 65(2)(e) is that it contains a general exemption for matrimonial property transfers. Where property subject to the provision is transferred under a matrimonial agreement, the spouse receiving the property is deemed to be a dealer in such property and is deemed to have acquired it for the acquisition price of the other spouse.

In practice, the more important limitations on the ambit of the section are those which have followed from judicial interpretations. They have meant that the provision has had little effect in widening the income tax base to reflect more clearly the true income of taxpayers. The first and third limbs have been interpreted to add little to other provisions of the Act. The second limb can operate to bring to tax speculative gains on property such as shares, although even in that area the provision can be difficult for the Commissioner to apply.

While not being particularly effective at widening the income tax base, section 65(2)(e) can operate punitively in those circumstances in which it does apply. For example, it is not entirely clear that a person who makes realised losses on property, in circumstances where a gain would be taxable under this provision, can deduct that loss. Arguably, the loss is a capital loss and non-deductible even though any gain would be taxable. This is because the loss can be interpreted as still being on capital account for which a deduction is disallowed by section 106(1)(a). Nevertheless, in practice, a deduction is generally allowed. For losses on the disposal of premises which would give rise to taxable profit under sections 65(2)(e) or 65(2)(f)/67, section 106(1)(l) arguably implies that a deduction is allowed.

Section 65(2)(e) can also result in a deduction where the taxpayer incurs no economic loss. This can arise where the taxpayer purchases shares carrying an entitlement to dividends. When the dividends are paid out, the share price falls. The loss in the value of the shares merely accounts for the fact that the

dividends have been distributed. If the taxpayer is able to deduct the loss from income, the result would be that the taxpayer would be able to receive a net deduction when its economic position is unchanged (assuming no net tax liability on the dividends).

Section 198 aims to limit the ability of taxpayers to exploit this opportunity. The section can deem dividends derived by the share purchaser to be part consideration for the sale of the shares and included in the purchaser's income. The section can apply where dividends constitute a recovery of purchase price and the taxpayer controls the company paying the dividend or has purchased the shares as part of a "scheme".

#### **2.4.4 The Foreign Investment Fund Regime (Section 65(2)(eb) and Part IVA of the Act)**

The Foreign Investment Fund ("FIF") regime is a recent dilution of the capital/revenue distinction by Parliament. By section 65(2)(eb), FIF income is assessable. FIF income is defined in Part IVA of the Act. The aim of these provisions is to ensure that New Zealand residents cannot avoid or defer tax by systematically accumulating income offshore in entities designed for that purpose.

The regime applies to interests in "foreign investment funds". Broadly, that is a property or income interest in a company or similar entity which derives mainly investment or passive income and which is not subject to New Zealand tax, or the tax of any other country with a comparable tax system, on all its income. The income from a FIF interest which is brought to tax is calculated, again broadly, as all distributions from the FIF plus the change in the market value of the FIF interest (adjusted for taxable distributions). In other words, realised and unrealised (but accrued) gains are recognised as income.

#### **2.4.5 Land Transactions (Sections 65(2)(f), 67)**

As previously noted, the first two limbs of section 65(2)(e) do not encompass profits or gains on transactions involving land. This is because land transactions are specifically dealt with by their own provisions which apply a more detailed set of rules bringing to tax income that would in most cases otherwise not be taxable under either ordinary rules or under section 65(2)(e).

The primary taxing provision is section 65(2)(f), which includes within a taxpayer's assessable income profits or gains to which section 67 of the Act applies. Section 67 sets out, in a detailed manner, various property transactions that are deemed to give rise to assessable income. The provision is relatively complex and is outlined in more detail in Annex 2.4. In broad terms,

it assesses gains on the disposition of land acquired with an intention of resale, gains made by land dealers, developers and builders (including gains made by taxpayers associated with such persons), and gains arising from the re-zoning, subdivision or development of land.

The section contains a number of specific exemptions. As with section 65(2)(e), there is a general exemption for matrimonial property transfers. Other exemption provisions generally apply where the land is used as the taxpayer's private residence or is the premises from which it conducts its business. In addition, farmland is normally outside the ambit of the section except where the taxpayer is a dealer, developed on builder (or associated with such a person).

Section 67 is specific in bringing to tax gains only in the year in which those gains are realised by way of a disposition. Accrued but unrealised income is not taxable under the section. This rule is modified by section 82 which enables the Commissioner to spread income derived from the disposition of land over the year the income is realised and the three subsequent income years where the land is acquired by the Crown.

In contrast to personal property subject to section 65(2)(e), land is specifically excluded from the definition of trading stock in section 85. However, land can be included in the wider trading stock definitions in sections 90, 91 and 197. Thus, dispositions of land are deemed to be sales at market value that can give rise to a tax liability under section 67.

Section 67 can be viewed as a provision duplicating and then extending section 65(2)(e), bringing to tax income that would not be subject to tax if the latter provision applied. The reason for treating land transactions separately from transactions involving other types of property appears to be the ease with which people could otherwise derive non-taxable income by holding land. It is notable that what is now section 67 was first enacted in 1973 at a time when land prices were rising rapidly, creating considerable disquiet about untaxed speculative activities in this area.

Nevertheless, the ambit of section 67 is still narrow. It does not generally bring to tax income derived from land held as an investment, even though an investor will consider the overall yield from the property (including capital growth) when making investment decisions. Instead, the section is deliberately limited to specific types of taxpayers (dealers, developers and builders) or specific types of transactions (gains from land acquired for re-sale, or gains resulting from rezoning or subdivision or development).

However, the categories subject to tax are necessarily arbitrary. For example, section 67(4)(c) taxes gains made by a builder who has effected improvements to the land where the land is sold within ten years of its acquisition. It does not apply to people who are not builders (or associated with builders). It does

not apply if no improvements are made to the land, and it does not apply if the land is held for more than ten years. The rationale would appear to be that builders are more likely than other taxpayers to derive income or gains of this nature as a direct substitute for other income-producing activities. Nevertheless, it can be difficult to defend a provision where two people carry out exactly the same activity and derive the same return, but one is taxed and the other is not because of differences in the nature of other businesses in which the taxpayers are engaged. Furthermore, it is difficult to rationalise a provision which taxes gains on land held for ten years but not gains on land held for ten years and six months.

Finally, because section 67 can determine the taxation status of a transaction according to the nature of a taxpayer's other business, in the absence of anti-avoidance measures it could have been possible to escape the operation of the section by having different transactions carried out by different taxpayers. For example, a company group could have carried out land development in one company and land investment in another. To prevent such techniques, the section treats persons associated with a dealer, developer or builder as a dealer, developer or builder. The definition of associated person (outlined in Annex 2.4) is wide. The result is that a taxpayer can find itself associated with another entity for the purposes of section 67 so that a tax liability under the section is incurred.

The problem here is that in trying to prevent tax from being easily avoided, the section may at times impose tax on those for whom the provision was not specifically intended. On the other hand, the restricted nature of the provision and the fact that it taxes only specified transactions and taxpayers, mean that if the precise requirements for a tax liability to be incurred are not met, no tax liability under the section is incurred.

The section embodies a number of features that taxpayers can exploit to their advantage. Thus, before gains from land acquired for sale are taxable under section 67(4)(a) there must have been a specific and crystallised purpose or intention to sell the land and that purpose or intention must have been present at the time the land was acquired. An example of the fine distinctions which can be involved is found in Harkness v. CIR.<sup>19</sup> In that case, the father of the taxpayer negotiated the purchase of land on behalf of his son. It was clear that the father saw this as an opportunity to resell at a profit. The son, who was the legal purchaser of the land, was about to embark on overseas travel. He had no particular purpose in mind except a vague notion that the land might constitute the basis for a future farm. It was held that the father's purpose in arranging the purchase of the land could not be imputed to the taxpayer. Since the taxpayer had no purpose of resale at the time of purchase, the gain was not liable to tax.

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<sup>19</sup> (1975) 2 NZTC 61,017. This case was based on the law prior to the enactment of section 67, but the principle is likely to remain the same.

As well as utilising such distinctions, taxpayers can also often defer or avoid tax under section 67 by holding the land in a company and disposing of shares in the company for a tax-free profit. This is, of course, provided the transaction is not taxable under section 65(2)(e). Where the associated persons rules can give rise to a liability, taxpayers have shown considerable ingenuity in skirting their application. The weaknesses of section 67 are therefore the inevitable weaknesses of a provision which is somewhat arbitrary and narrow in its application.

A further problem with the section is that, as with section 65(2)(e), there are schematic problems concerning the appropriate treatment of losses and expenditure. There is some doubt as to the deductibility of losses on a transaction for which gains would have been taxable. Again, it is arguable that losses could be on capital account and therefore non-deductible.

The provision is also unclear as to when expenditure incurred in purchasing or developing land is deductible. On one view, such expenditure is offset against the eventual gain and recognised at that time. A contrary view is that the expenditure can, if it is on revenue account, be deducted at the time it is incurred, which can be a number of years before the eventual gain is realised. According to this view, a person could deduct the full purchase price of the land at the time of purchase and return the gross receipts from resale at the time of disposal. In other words, land is treated as trading stock, but, unlike ordinary trading stock, land is excluded from section 85 which offsets the deduction for purchasers by bringing the value of trading stock on hand back into assessable income. The arguments vary amounting to the precise provision in section 67 which operates to make gains assessable.

#### **2.4.6 Provisions That Restrict Deductibility of Expenditure Relating to Land Transactions**

##### **(Sections 129 and 188A)**

The above provisions still allow some taxpayers to invest in land so as to produce tax-free returns while at the same time expenditure incurred on the investment (particularly interest on funds borrowed to make the investment) may be set-off against other assessable income. This was seen as being a particular problem where the expenditure on the investment received concessionary tax treatment (i.e. immediate deductibility for expenditure producing lasting assets), such as was the case with respect to farming and horticultural development expenditure.

Rather than attack this problem at its source (the immediate deductibility of capital expenditure and the non-taxation of income from gains in the value of the investments), the approach taken in 1982 was to attempt to restrict the use of losses and to recover interest and development expenditure deductions in certain circumstances.



The loss restriction provision is section 188A. As initially enacted, that provision restricted the losses from rental, agricultural and horticultural activities that could be offset against other income to a maximum of \$10,000 per taxpayer per annum.

The interest and development expenditure recovery provision is section 129. The provision applies where land is sold within ten years of acquisition and a profit is derived on sale of the land that is not otherwise assessable under any other provision of the Act. As initially enacted, where section 129 applied it clawed back interest and development expenditure deductions incurred with respect to the land sold for a profit by including those amounts (up to the amount of gain made from the sale of the land) in the taxpayer's assessable income.

As with many provisions that attempt to tackle one problem area by applying selective penal treatment to another (albeit related) area, sections 129 and 188A were widely perceived to be unfair. At the same time, the narrow and selective nature of the measures made it possible to frequently escape their operation. One strategy has been to hold the land in a company and to incur interest on funds borrowed to buy shares in that company. In that way, no interest is incurred with respect to the land, so there can be no clawback of interest deductions under section 129.

For related policy reasons and in recognition of these problems, farming and horticultural activities were removed from the ambit of the provisions at the same time as the immediate deductibility of farming development expenditure was removed. Sections 129 and 188A continue, however, to apply to interest in respect of land held for rental.

#### **2.4.7 Payments Under Leases (Sections 65(2)(g), 70, 136-139, and 222A-222E)**

Section 65(2)(g) is a general provision including in assessable income rents and other income from land. For the most part, such receipts would be income under ordinary concepts, with the general rule being that payments are assessable in the year they are receivable. An exception is certain forms of goodwill payment which the section specifically brings into income.

As a general rule, New Zealand law does not include receipts for the sale of goodwill within the vendor's assessable income because such payments would normally be considered to be receipts on capital account. However, section 65(2)(g) includes within the definition of assessable income payments for or in respect of goodwill of any business, or the benefit of any statutory license or privilege, derived by the owner of land from any lease or similar interest affecting the land. The effect of this provision is to bring into assessable income goodwill payments received on the lease of land. Section 65(2)(g) does not make

taxable goodwill payments received on the outright sale of the land. It has also been held<sup>20</sup> that the section taxes payments for site goodwill but not payments for business goodwill. The distinction is that site goodwill attaches to the actual geographic location or special features of the land being leased, whereas business goodwill attaches personally to the proprietor of the business. The distinction is easier to state than it is to draw.

Section 65(2)(g) is an attempt to avoid allowing taxpayers to transform lease payments (which would generally be taxable payments received on revenue account) into a non-taxable receipt received on capital account. For that reason, section 65(2)(g) includes in assessable income premiums as well as goodwill received by a lessor. <sup>21</sup>Section 80 of the Act then allows the Commissioner to spread premiums, goodwill and like payments made "by way of anticipation" on the grant of a lease over up to six years.

Deductibility of such payments is provided for in section 137. This provision allows a deduction for premiums and goodwill payments by a lessee, with deductibility apportioned evenly over the term of the lease.

Sections 70 and 138 of the Act have a similar purpose to that of sections 65(2)(g). Section 70 includes within the assessable income of a lessor any payment received by way of compensation or damages for failure by any person to perform any obligation under a lease of land or to maintain the land. Such payments can be spread over the year of receipt and the four subsequent years. Section 138 allows a deduction for compensation or damages payments made by a lessor. The deduction is allowed in the year the payment is made or over the three preceding income years.

These provisions demonstrate how it has been found necessary to move the traditional capital/revenue boundary to hinder the ability of taxpayers to transform otherwise assessable income into income on capital account which would not be subject to tax. Such transformation problems are inherent in a tax system that taxes some forms of income but not others. As illustrated by the need to distinguish between site goodwill and business goodwill, as the boundary moves, the problem moves with it.

The provisions discussed above apply only to payments under leases of land. For leases of most other assets, the Act distinguishes between "specified" and "non-specified" leases. In broad terms, a "specified lease" is a lease of property (other than land, livestock or bloodstock) under which many of the risks of ownership are transferred from the lessor to the lessee. For a specified lease,

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<sup>20</sup> Romanos Motels v CIR [1973] 1 NZLR 435

<sup>21</sup> It is noted, however, that in Romanos Motels it was held that a goodwill payment need not be a disguised lease payment to be subject to the section.

sections 222A to 222D deem the lease to be a sale, financed by a vendor loan, of the leased asset for its cost price. Rental payments made by the lessee are treated as repayments of loan capital and interest. The interest portion is assessable income of the lessor and expenditure of the lessee, being assessable or deductible on an actuarial basis over the term of the lease.

For non-specified leases of assets other than land, no special rules apply with the following two exceptions. Under section 222E, for deduction purposes lease payments are apportioned evenly over the term of the lease. Under section 139, premiums with respect to leases of any machinery used in the production of assessable income are deductible, with deductibility spread over the term of the lease.

Finally, under section 136, expenditure incurred in preparing, stamping and registering a lease of any property (including land) used in the production of assessable income is deductible.

#### **2.4.8 Other Income From Land (Sections 74, 81A, 127-128C, and 214A-222)**

Other receipts from land that would not be included in assessable income under ordinary principles may be included under section 74 of the Act. Section 74(2)(a) includes within assessable income "all profits or gains derived from the use or occupation of any land." While the wording may appear wide, "profits or gains" would generally be measured by applying ordinary tax rules and thus the provision would exclude income on capital account.

Specific rules cover the deductibility of farming and agricultural expenditure. Under section 127, immediate deductibility has been allowed for land improvements and development that might otherwise have been on capital account and therefore non-deductible. Under the primary sector tax reforms enacted in 1986, that concession is being phased out and under section 128A such expenditure is now to be amortised, normally at 5 per cent of diminishing value. Similar provisions apply under sections 128 and 128C with respect to aquaculture.

Of more significance in diminishing the capital/revenue distinction is section 74(2)(b), which includes in assessable income profits or gains derived by a taxpayer from the extraction, sale or removal of minerals, timber or flax. Section 74(5) also includes in assessable income the gain from selling standing timber together with the land. Under ordinary rules, such income would generally be assessable only if it fell within the business income of the taxpayer.

In ascertaining the assessable income under these provisions, the cost of producing the minerals, timber or flax is deducted from the gross sale proceeds except to the extent to which such expenditure has been previously deductible. With respect to mineral and petroleum mining, section 74 is supplemented by specific rules set out in sections 214A to 222. Those regimes are currently being reviewed.

The taxation treatment of forestry is set out in sections 74, 127A and 128B of the Act. This follows the 1986 review of the taxation of this sector. The overall effect is that some expenditure is immediately deductible under section 74(3), expenditure on preparing and developing land is amortised on a basis similar to farming development expenditure, and other expenditure is deductible when income is derived under section 74 from the sale of trees or timber.

There are four main exceptions to the rule that income from a forest is assessable on realisation. First, section 74(5) does not include in assessable income a sale of standing timber where the trees were planted for ornamental or incidental purposes. This includes trees planted as a shelter belt or for erosion control. Secondly, there is an exemption for matrimonial property agreements. Thirdly, it has been held<sup>22</sup> that section 74 captures profits from land but not from an interest or estate in land except to the extent to which section 74(5) applies. Thus, if a person who has rights to cut a forest makes a gain by selling those rights to another party, that gain is not assessable under section 74 (although it may be assessable under other provisions). This is a further example of how when, in an effort to capture all income, the capital/revenue boundary is moved, new problems can arise on the new boundary.

Finally, where the income is assessable, section 81A allows a taxpayer to have the income spread over the year it is realised and the three preceding years.

#### **2.4.9 Royalty, Patent and Copyright Income**

**(Sections 65(2)(h), 83, and 142-144)**

Probably one of the more significant and least appreciated dilutions of the capital/revenue distinction is the definition of a royalty. All royalties are included in assessable income by virtue of section 65(2)(h).

The term "royalty" in its ordinary meaning is broadly a payment for the use of an invention, a composed or written work, or some other intellectual property. Payments for intellectual property have never easily fitted within the traditional capital/revenue distinction. Strictly applied, orthodox treatment would regard a payment for the use of intellectual property as income on revenue account, but a transfer of a right to that property, otherwise than in

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<sup>22</sup> Smith v CIR [1969] NZLR 565

the course of a business, to be on capital account. The distinction between the use of and right to property is often finely drawn. Where the asset is intangible, as is the case with intellectual property, the boundary is quickly blurred to the point where it is often impossible to discern. For that reason, most countries have legislatively redrawn the boundary, or removed it and subjected all intellectual property income to tax.

New Zealand's approach is towards including all intellectual property income within the tax net. Since 1980, when the relevant provisions were last redrafted, a "royalty" has been defined in section 2 of the Act in a comprehensive manner to include all such income as well as income from property that would not ordinarily be thought of as a royalty. The definition of royalty in section 2 is discussed in more detail in Annex 2.5.

The Act also provides a specific taxation regime with respect to patents and patent rights. Section 83 deems assessable income to include the proceeds from the sale of patent rights, with an exemption for matrimonial property agreements. In ascertaining such proceeds, a deduction is permitted for otherwise non-deductible expenditure incurred by the taxpayer in devising the invention to which the patent relates, or the otherwise non-deductible cost of the patent rights. The net income is able to be spread over the income year in which it is derived and a period up to the five subsequent income years.

The expenditure incurred in devising or purchasing a patent may be deductible (otherwise than under section 83) under ordinary rules (if it is expenditure on revenue account) or under sections 142 and 143. Section 142 allows a deduction for expenditure incurred in purchasing a patent right used in the production of assessable income. The deduction so allowed is spread over the unexpired term of the patent right. Section 143(1) allows a deduction in the year incurred of any expenditure incurred with respect to the grant, maintenance or extension of any patent. Section 143(2) allows a deduction for devising an invention for which a patent is granted.

Finally, section 144 allows a deduction for expenditure incurred on scientific research carried out for the purpose of deriving assessable income. The provision, however, does not allow a deduction for expenditure relating to depreciable assets.

As wide as the definition of royalty is, it does not extend to cover a payment for an asset interposed between the purchaser and the right. Thus, a taxpayer wishing to sell a patent could instead sell a company that possesses the patent. A royalty would not generally be deemed to arise with respect to the payment for the company. This is again a demonstration of how the difficulties inherent in the capital/revenue distinction can re-emerge on any new boundary line that is drawn.

## 2.4.10 Income From Financial Arrangements

### (Sections 64B-64M, 65(2)(j))

The difficulty in sustaining the traditional capital/revenue distinction is particularly acute with respect to financial instruments.

Under the traditional capital/revenue distinction, returns from financial instruments could be non-assessable capital account income. This was the likely position where the income from the instrument could be attributed to an accretion to its value and the taxpayer was not in the business of making such gains. Thus, in Willingale v. International Commercial Bank<sup>23</sup> the House of Lords affirmed that the term "interest" in its ordinary sense did not include a discount or premium on a financial instrument. Where such gains were made by a taxpayer in the course of business, they were taxable as business profits<sup>24</sup> but not as interest income.

Outside of those circumstances, a premium or discount was usually regarded as non-taxable to the lender, provided it was not clearly a payment in substitution for ordinary interest applying to reasonably sound securities. The more such a gain could be said to reflect the risk assumed by a borrower and the less it was clearly tied to compensation for the time value of money, the greater the possibility that the gain would be held to be on capital account.<sup>25</sup>

To a large extent, a financial instrument providing a return in a form that has traditionally been viewed as ordinary income (e.g. interest) is perfectly substitutable by a financial instrument that provides the same return on the same terms but in the form of an accretion in the value of the financial instrument itself. Thus, a person can be expected to be indifferent between receiving a coupon interest payment of \$100 in a year's time and being paid in a year's time, on redemption of the instrument, \$100 more than they acquired it for.

This is a graphic illustration of the irrelevancy of the traditional distinction between capital and revenue receipts when measuring a person's true economic position. The flexibility of the financial system highlights and makes more acute the problems of operating a tax system based upon such a distinction. For that reason, few countries with developed tax systems retain the capital/revenue distinction with any degree of rigidity with respect to financial instruments. Indeed, as early as the United Kingdom Income Tax Act of 1805, "profits on discounts" were expressly subjected to income tax.

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<sup>23</sup> [1978] 1 All ER 754

<sup>24</sup> as was the case in Beazley v. CIR (1980) 4 NZTC 61,527

<sup>25</sup> Lomax v Peter Dixon & Co. Ltd (1943) 2 All ER 255

New Zealand moved away from a strict capital/revenue demarcation in taxing financial instruments some time ago. Hence, we have had a relatively wide definition of interest income under section 2 of the Act which has been deemed to be assessable under section 65(2)(j). The assessability of returns from financial instruments was further widened by section 65(2)(ja) - benefits from money advanced - and sections 65(2)(k) and (ka) - redemption payments. Nevertheless, the income tax system still operated to leave some forms of income under financial instruments untaxed.

An additional problem with financial instruments was that income that was taxable was not taxable until received or receivable, while the same payment could be deducted at a much earlier time, as soon as it had been incurred by a taxpayer.

The accrual rules, largely set out in sections 64B to 64M of the Act and enacted with general effect from 1986, set out to rectify these problems. They had the twin aims of removing such gaps by largely removing the capital/revenue distinction in this area, and of recognising the income and expenditure under financial instruments on an accrual basis. The accrual rules are explained more fully in Annex 2.6.

#### **2.4.11 Additional Provisions Allowing a Deduction for Expenditure on Capital Account**

**(Sections 124 and 125)**

Section 124 of the Act allows deductions for expenditure aimed at preventing or combating pollution of the environment. That expenditure expressly includes the construction of earthworks, ponds, and settling tanks. Section 125 provides a deduction for expenditure on energy conservation and encompasses a wide range of expenditure which would otherwise be non-deductible.

### **2.5 Income From Capital Which is Not Taxed**

As demonstrated by the above survey, the capital/revenue distinction developed by the courts has been considerably restricted by legislative provisions as it has become apparent that, in particular areas, the capital/revenue boundary had become unsustainable. While these developments have widened the income tax base, the reforms have tended to be piecemeal. The result is that, despite the numerous provisions subjecting to tax forms of otherwise non-taxable income, there are many forms of income that remain untaxed or inappropriately taxed because of the ability of taxpayers to claim an exemption on the grounds that income is on capital account. This section outlines examples of such untaxed income.

### **2.5.1 Income from Investing in Land**

One of the more common forms of untaxed income is income from investments in land, including commercial and industrial property, farms and housing. Such investments normally produce an overall expected yield consisting partly of rents (and any other ordinary income derived from utilising the land), and partly of growth in the market value of the land and building(s). As with returns from financial instruments and intellectual property, investors recognise that ordinary income and any accretion in the value of land and buildings are part of the overall return that they obtain.

It is for this reason that the legislative dilution of the capital/revenue distinction has tended to concentrate on these areas. However, whereas the taxation of income from financial arrangements is now relatively comprehensive, and the definition of what constitutes taxable income from intellectual property is widely drafted, provisions taxing income from holdings of land are still relatively narrow. Thus, someone who buys commercial property for a return consisting of rents and capital growth will generally not be obliged to pay tax on the latter form of income where such gains do not constitute business income and the income does not fall within the specific taxation provisions in section 67. Because of the relatively narrow scope of both those tests, it is likely that most income escapes taxation.

### **2.5.2 Income from Investments in Shares**

Unlike income from investments in land, there are no provisions specifically aimed at bringing to tax income from the increase in the value of shares in companies. If a taxpayer can reasonably assert that such income is neither business income nor within the relatively narrow ambit of section 65(2)(e), no tax should arise. This makes it unlikely that those who hold investments in shares on a relatively long-term basis are taxed on any gains on sale. Where such gains are not attributable to after-tax retained corporate earnings, the result is to produce a tax bias in favour of that form of income. In addition, it is often possible for taxpayers to convert otherwise assessable income into a gain on a shareholding. An example is where tax on the sale of land under section 67 is escaped by a taxpayer who sells a company which owns the land.

### **2.5.3 Income from Investments in Other Assets**

There are a range of other assets that can produce expected gains that similarly can result in untaxed income to the investor. Thus investments in assets ranging from commodities (such as gold) through to collectables (such as significant art works, antiques, jewellery and vintage cars) can give rise to untaxed income. Collectables, in particular, are often offered for their investment value.



#### 2.5.4 Income from Goodwill

Aside from the direct investment in such assets, investors may invest in developing their own businesses. Where successful, this can produce significant untaxed income by way of "goodwill" (an excess in the market value of a business over the market value of its tangible assets). Thus, a person can develop a business, sell that business for a substantial gain and pay no tax on the profit.

There is therefore a tax incentive for a business to emphasise factors increasing goodwill (such as market and brandname awareness) to the detriment of deriving current taxable income. Moreover, in most cases expenses associated with increasing goodwill are directly or indirectly deductible. For example, most advertising expenditure will be immediately deductible with the caveat that a large-scale once-only campaign related to a firm's goodwill could be held to be non-deductible expenditure on capital account.<sup>26</sup> Immediate deductibility of such expenditure is usually not barred by section 104A because the service (advertising) is performed in the relevant income year. It is the benefits from that service which are long-term.

Thus, existing law often allows a person to deduct expenditure creating an asset and then sell the asset for an untaxed profit. The importance of such gains for business enterprises should not be under-estimated. The high prices now often paid for firms that have recognised brandnames, and recent moves to incorporate such assets in the financial statements of public companies, indicate the significance attached to such intangible assets and to the untaxed income which they can generate on sale.

#### 2.5.5 Income from Personal Restrictive Covenants

A restrictive covenant is an agreement by which someone agrees not to conduct business or to work for a specified time in a particular area of operations or locality. Restrictive covenants are frequently used as a means by which an employer protects a business from departing employees leaving and setting up in competition using in the process information or client contacts developed while working with the firm. Payments to employees in return for consenting to be bound by restrictive covenants can represent capital account payments similar to payments received on the sale of a business's goodwill. In consideration for a payment from a firm, the employee agrees to forgo utilising an element of the human capital which he or she has accumulated.

English and Australian cases support the contention that such payments to an employee can be non-taxable income of the recipient, being a payment received on capital account.<sup>27</sup> In New Zealand, the Inland Revenue Department has stated that it accepts that such payments are not taxable <sup>28</sup>as either monetary

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<sup>26</sup> Sun Newspapers Ltd v. FCT (1938) 61 CLR 337

<sup>27</sup> Beak v. Robson [1943] 1 All ER 46; and FCT v. Woite 82 ATC 4,578

remuneration of the employee or as a fringe benefit under the fringe benefit tax provisions. Payments made by an employer will also generally be on capital account and thus non-deductible<sup>29</sup> although it is conceivable that in some circumstances such payments could be on revenue account.

Inducement payments made to a prospective employee can also be argued to be non-taxable capital account income if the payments are made to induce the person to forgo another opportunity rather than in relation to a future employment relationship. The Inland Revenue Department, however, does not readily accept such a distinction and regards inducement payments as taxable monetary remuneration. In either case, the employer will often be able to claim a deduction for expenditure incurred in making such payments, along with other staff recruitment costs.

## 2.6 Tax Rules Applying to Particular Entities

In addition to the general rules described above, there are a number of specific rules relating to income generated in relation to particular entities. This section covers specific rules relating to: partnerships, trusts, companies, life offices and superannuation schemes, and controlled foreign companies.

### 2.6.1 Partnerships

Although a partnership is a "person" for the purposes of the Income Tax Act and as such is liable to file an annual return of income, the Act, in particular section 10, generally looks through partnerships and treats the partnership as a type of joint venture with individual partners deriving and incurring their proportionate share of partnership income. This reflects the legal nature of a partnership, which is that it is not an entity distinct from the individual partners.

The main exceptions to this general proposition are section 211B (which prohibits a net loss on the activities of a special partnership<sup>30</sup> from being offset against the other income of the constituent partners) and section 167B (which allows certain working partners to be treated as if they were employees of the partnership). Aside from those provisions, the income generated through a partnership is generally taxed as if it were derived directly by each partner.

The main issue is the consequence of a reconstitution of a partnership by the admittance of a new partner and/or the death or retirement of an existing partner. This is an area of some confusion and practice tends to be dominated by past procedures rather than arguments on the finer points of law.

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<sup>28</sup> Technical Rulings, Chapter 11, para 2.2.10

<sup>29</sup> Buckley & Young v. CIR [1978] 2 NZLR 485

<sup>30</sup> A partnership which meets the requirements of the Partnership Act 1908 to have limited liability for most of the participating partners.

Arguably, a partner does not own specific assets which go to make up overall partnership property. Such property must be applied for the purposes of the partnership and not for the benefit of an individual partner. Instead of owning specific property, each partner owns a proportionate share of the overall assets of the partnership.

It would also seem to be the legal position that when a partnership is reconstituted, the old partnership is dissolved and a new partnership consisting of the remaining and/or new partners is formed.<sup>31</sup> That is arguably the case even where the partnership deed has a contrary provision because for income tax purposes a new person comes into being on each such occasion. If those arguments are correct, every reconstitution of a partnership could be said to result in the disposal of all partnership assets with a resulting tax liability on any accrued taxable income deemed to be realised by the disposal of the assets.

The Income Tax Act specifically deals with two circumstances where partnerships are reconstituted. Section 85(8) is a general provision deeming the disposal of business assets (by sale, gift or death) that include trading stock to constitute the sale of the trading stock for its market value. That provision applies to the disposal of partnership assets. It is modified by section 85(4B) which allows, with respect to specified livestock, the trading stock of the reconstituted partnership to continue to be valued on the same basis as that adopted by the prior partnership.

Section 117(9) is a more specific provision that applies where an asset for which depreciation has been allowed is sold or disposed of as a result of the reconstitution of a partnership. In those circumstances the Commissioner is empowered to apply a clawback of prior depreciation where the asset is disposed of for more than its book value.

The practice with respect to partnership reconstructions is to regard new partners entering a partnership as purchasing their share of partnership assets from the other partners. Where an existing partner retires or dies, the other partners are regarded as having purchased the retiring partner's share of partnership assets. This can give rise to taxation consequences where any partnership asset creates a realised tax liability on sale under section 67, the accrual rules or any other provisions. However, the Inland Revenue Department does not assert that partnership reconstitution results in the complete sale of total partnership assets so that taxable gains are realised by continuing partners. The position where a partner contributes assets (on which a tax liability arises on realisation) to a partnership is even less clear, but the general practice seems to be to deem an appropriate proportion of the asset to be sold to the other partners.

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<sup>31</sup> Tikva Investments Pty Ltd v. FCT 72 ATC 4231

## 2.6.2 Trusts

A trust is similar to a partnership in that it is not itself a separate legal entity. When something is described as being a trust, what is meant is that the relevant property is held by the legal owner, the trustee, subject to certain equitable obligations. Trusts are subject to a specific tax code set out in sections 226 to 233 of the Act.

A trust is effectively ignored for tax purposes where income from property subject to the trust is attributed within a year and six months to specific beneficiaries. In that case the income is generally taxed as if it were derived directly by the beneficiary. Where income and gains are accumulated, the Act looks to the trustee as the deriver of any taxable income. Taxable income is then calculated according to normal income tax rules, except that a trustee is taxable on income sourced outside New Zealand only if the settlor of the trust is a resident of this country or on the death of such a settlor.

A tax liability can also arise on trust distributions of income accumulated in prior years. In determining whether there is such a liability, the Act distinguishes between three types of trust:

- **a qualifying trust** - where income of the trust has always been subject to New Zealand tax since its inception. Distributions from a qualifying trust are not subject to tax;
- **a foreign trust** - broadly, a trust with no resident settlor since inception, which therefore has never been subject to New Zealand tax on foreign-source income. Distributions from a foreign trust are taxable at normal rates. The exceptions are distributions to the extent that they represent the return of the amount originally settled on the trust, and realised net capital profits or gains that would not be taxable under the Act and that are not the result of a transaction with an associated person of the trustee. Distributions within these exceptions are not taxed; and
- **a non-qualifying trust** - a trust which is neither qualifying nor foreign. Distributions from a non-qualifying trust are taxable along the same lines as distributions from a foreign trust. There are, however, two important differences. First, distributions from a non-qualifying trust are taxed at a higher rate. Secondly, although distributions representing the return of the amount settled on the trust are not taxed, distributions of net capital profits or gains are taxed. That is, the normal taxation exemption for income on capital account does not apply if the income is in the form of a non-qualifying trust distribution.

### 2.6.3 Companies

Unlike partnerships and trusts, a company is a separate legal entity from the individuals who ultimately own its assets. It is treated as such for income tax purposes. In addition, the definition of a company includes some other entities such as unit trusts as defined in section 211 of the Act.

Companies are liable to tax on income that they derive. On the whole, their income is calculated by applying the income tax rules that apply to other taxpayers. A significant exception is the section 63 inter-corporate dividend exemption. Section 63 provides that most companies that are resident in New Zealand are generally not required to include in their assessable income any dividends received from most other companies. The reason is to avoid multiple taxation of profits passing as dividends from one company to another. The section 63 exemption includes most dividends received from non-resident companies, although such dividends are subject to dividend withholding payments under Part XIIB of the Act.

Companies are also subject to restrictions on their ability to carry forward losses from one income year to the next. Under section 188 of the Act, individuals can generally carry forward losses from one year to the next without restriction. However, the losses of one individual cannot be offset against the income of another individual. For companies, losses carried forward must meet a test requiring 40% continuity of ultimate individual shareholders. Under section 191, companies can utilise losses against the income of other companies if the requirements of that section are met. The more important requirements are that there must be at least two thirds common share ownership (an ordinary group) for losses to be utilised by way of a transfers of funds known as subvention payments from the taxpaying to the tax loss company, or 100% common share ownership (a specified group) for losses and income to be directly offset against each other.

Finally, under section 191(4A), where two or more companies form a specified group (100% common ultimate share ownership), any gain made by one company in the group is taxable if such a gain would have been taxable if derived by another member of the group. For example, if one company derives a non-taxable gain from the sale of shares, but it is a member of a specified group with a company that is taxable on such gains, then section 191(4A) could possibly be applied to bring the gain to tax.

A second aspect of the company tax system is the taxation of a distribution from a company. Any such distribution which constitutes a dividend is taxable to individual shareholders under section 65(2)(j). Under the previous classical corporate tax system that applied in New Zealand until 1 April 1988, the taxation of corporate income was taxed twice, once when derived by the

company and a second time when distributed to shareholders. However, that double tax is largely removed by the imputation system set out in Part XIIA of the Act. Imputation allows the tax on dividends to be offset by a credit for tax paid at the company level.

Nevertheless, imputation still means that where a company derives non-taxable income (such as income on capital account) and distributes that income in the form of a dividend, full taxation will be levied on the dividend distribution. The reason is that, the gains being tax-free in the hands of the company, the company has no tax credits to impute to shareholders along with dividends. Thus, company level taxation under an imputation system has been described as a withholding tax with an adjustment for any over- or under-taxation on dividend distribution. The implication is that an exemption from tax on corporate income (such as the non-taxation of corporate income on capital account) is eventually clawed back to some extent.

In most cases, a company distribution is taxed only if it constitutes a dividend. A dividend is widely defined in section 4 of the Act and includes a distribution of company income that was not taxed at the corporate level on the basis that it was on capital account or otherwise not specifically brought to tax by any provision of the Act. However, section 4A excludes various distributions from the dividend definition including any "capital gain" distributed to an unrelated corporate shareholder or a non-corporate shareholder upon the winding up of the distributing company.

To constitute a "capital gain", the profit must be a gain that is not subject to tax when derived and most have arisen from the realisation of a capital asset as a result of a transaction with an unrelated party (although sales to related individual shareholders of a private companies as part of the winding up process are acceptable transactions for this purpose), or otherwise be considered to be a "capital gain" (for example, a gift). A distributed "capital gain" also includes the in specie distribution of a capital asset to the extent that the market value of the asset exceeds its cost price. "Capital losses" incurred in the year in which a "capital gain" is realised, or in any subsequent year, must be deducted from the amount calculated as a "capital gain" to calculate the amount available for distribution purposes. That excludes "capital losses" incurred in transactions with related parties.

Following the principle in Smout v. CIR<sup>32</sup> a qualifying "capital gain" distributed tax-free to a non-related company assumes "capital gain" status in the hands of the recipient company and thus, in turn, is eligible to be distributed tax-free on winding up.

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<sup>32</sup> (1982) 5 NZTC 61,158

As a result of these rules, untaxed income on capital account derived by a company that is distributed in circumstances and in a manner that meets the requirements of a tax-free distribution retains its tax-free status. Where untaxed income on capital account is later distributed in a manner that incurs a tax liability some of the benefits of the original tax-free aspect of the income will be clawed back although an advantage from deferring the tax liability will usually remain.

#### **2.6.4 Life Offices and Superannuation Schemes**

Under our income tax system, life offices, with respect to their life office business, have been regarded as a conduit through which policyholders derive investment income. In relation to life office business they conduct, life offices have therefore been taxed as a proxy for those policyholders, rather than being taxed in their own right as an insurance business.

As a result, life insurance has been subject to a special taxation regime under section 204 of the Act. In accordance with the proxy concept life offices have not benefited from the inter-corporate dividend exemption and have been able to offset tax on dividends with imputation credits. On the other hand, life insurance income does not give rise to imputation credits distributable with dividends paid to shareholders.

Life offices have also been specifically taxed on any profit or gain from selling or disposing of an investment. With respect to investments acquired on or after the year ending 31 March 1983, the taxable profit or gain on an investment is the difference between sale proceeds and cost price. With respect to other investments, it is the difference between sale proceeds and the greater of cost price and the market value of the investment on the last day of the 1983 year.

This aspect of the tax treatment of life office investments is not designed to widen the tax base beyond what ordinary income tax rules would tax. Instead, it has been considered to be a codification of the normal rule applying to insurers, banks and similar organisations that the realisation of investment gains is part of the inherent operations of such businesses and therefore taxable as ordinary income.

The life office taxation regime has been the subject of recent review. Following the report of the Consultative Committee on the Taxation of Life Insurance and Related Areas, the Government has announced that it is bringing in a revised taxation regime that will tax life offices on a basis that more closely reflects the ordinary tax treatment of companies. Life offices will pay tax on income derived from their insurance operations. That will include investment income, including realised investment gains, but life offices will now benefit from the normal inter-corporate dividend exemption and will be subject to an

imputation regime on a similar basis to other companies. Life offices will also pay tax, on behalf of their policyholders, on sums attributable to those policyholders subject to offsetting imputation credits. Such attributed income will include attributed "capital gains" irrespective of whether or not such gains are realised. This rule aims to follow ordinary dividend rules for companies.

Life offices may have assets attributable to superannuation funds included within their life fund. The general rule now is that superannuation funds have no special tax rules but are taxed along the same lines as trusts. They are not specifically subject to tax on realised investment gains, although such gains may be taxable under ordinary rules. Nevertheless, superannuation fund investments held as part of a life office's life insurance business are still taxed on realised investment gains in the same way as investments attributable to individual policyholders.

There are also special transitional rules for superannuation schemes that were in the past subject to tax. Under section 225, they were specifically subject to tax on realised investments on the same basis as life offices under section 204. Under sections 225A and 232B, realised investment gains or losses for such previously taxed schemes remain taxable or deductible on the same basis as in the past to the extent that such a gain or loss accrued prior to 1 April 1988.

### **2.6.5 Controlled Foreign Companies**

Controlled foreign companies ("CFCs") are foreign companies controlled, directly or indirectly, by five or fewer New Zealand residents. Under Part IVA of the Act, New Zealand residents with an income interest of 10% or more in a CFC are taxed on their share of the underlying income of such entities. That underlying income is, in general, calculated by applying the appropriate income tax rules for an offshore branch of a New Zealand resident company. In that way, CFC income is measured according to the features of New Zealand income tax law, including the exemption of income on capital account, subject to the specific statutory extensions of the income tax base that have been outlined in this chapter.

## **2.7 Conclusion**

The exemption from tax of some forms of accretions to wealth on the basis that they are on capital account is largely a result of historical developments. It is not related to the way people view investment decisions, nor is it related to the way they view their own economic position.

The distinction between taxed and untaxed income is difficult to define. Indeed, one of our leading judges has declared that drawing the boundary is "an intellectual minefield in which the principles are elusive and analogies treacherous".<sup>33</sup>

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<sup>33</sup> Richardson J in *CIR v McKenzies New Zealand Ltd* 10 NZTC 5,233 at page 5,236



For that reason, the application of the original judicial distinction between capital and revenue has long ago been considerably restricted by specific statutory provisions. Moreover, where the exemption for income on capital account continues, and where such exempt income is derived by a company, the exemption will usually be clawed back to some extent by way of tax on dividend distributions. Few people would now argue for repeal of all those provisions that have changed the traditional capital/revenue distinction. That would open possibilities for people to arrange their affairs to derive exempt income to such an extent that the entire income tax burden could be placed on the shoulders of wage and salary earners.

Opposition to any reforms in this area is therefore a call for a halt in the process which has continued for many years whereby the definition of "income" has been extended. It is difficult to view this as a matter of principle. The practical issue is the extent to which reforms can be put in place that would improve the efficiency and equity of the tax system without undue costs in terms of compliance, administration and complexity. This is the subject of this Document.

The above review of current law suggests that it is less than satisfactory. The current rules can be complex. They result in some taxpayers being over-taxed and others being under-taxed.

Nor, as this chapter shows, is it true to say that current law has removed most anomalies and most possibilities for taxpayers to escape tax on the income they earn. The provisions covering financial arrangements and, to a lesser extent, intellectual property are relatively comprehensive within those areas. Another area where attempts have been made to bring income on capital account within the tax net is land transactions. However, the provisions in this area tend to be narrowly focused, which results in anomalies between different taxpayers and different transactions and allows knowledgeable and well-advised taxpayers to escape tax.

Outside these areas, statutory provisions tend to be weak and often obscure. The result is that significant income is untaxed, with a resulting higher tax on other forms of income. In addition, bringing some forms of income on capital account to tax while leaving other forms of such income untaxed merely shifts the boundary between taxed and untaxed income. This creates new problems on the new boundary, with taxpayers showing a natural inclination to emigrate across to the area where income is not taxed. A simple example of this is turning taxed land transactions into an untaxed company share transactions.

The lesson from the problems experienced with current law therefore is that the definition of taxable income should be as comprehensive as possible, reflecting as far as possible the reality of each taxpayer's income. This is most likely to produce the least costly tax, and a tax which is most likely to be perceived to be fair.

## **ANNEX 2.1 Depreciation**

### **Section 108**

It is standard accounting practice to allow for depreciation when measuring the profitability of an enterprise. Nevertheless, a deduction for depreciation is not available for income tax purposes except to the extent that that is specifically allowed for under the Income Tax Act. A deduction for depreciation allowances is provided for under section 108. The same section also provides a deduction for expenditure on repairs and maintenance.

The wording of section 108 has been criticised by judges for being obscure. Moreover, the relationship between that section and other provisions, especially sections 104 and 106, is unclear. The drafting of section 108 was strongly criticised by the Court of Appeal in Auckland Trotting Club (Incorporated) v CIR<sup>34</sup> but has not been amended to correct the main problems identified in that case.

Section 108 proceeds by denying a deduction for expenditure on repairs to premises and the repair and maintenance of plant, machinery and equipment beyond usual annual expenditure of that nature. A curiosity of the provision is that it then provides for other repair and maintenance expenditure deductions and depreciation by way of provisos to the initial denial of a repair and maintenance deduction. A feature of the depreciation proviso is that the depreciation allowance allowed is left substantially at the discretion of the Commissioner of Inland Revenue. Allowing depreciation as a discretionary allowance enacted by way of proviso is a feature of the current income tax legislation which has been criticised.

### **Method Adopted for Calculating Depreciation**

In general, a depreciation allowance is calculated by taking the cost price of a depreciable asset (premises, plant, machinery or equipment used in the production of assessable income) and amortising it at a rate approved by the Commissioner. Amortisation is normally on a diminishing value basis although straight line depreciation is allowed in some cases. Section 111 allows the Commissioner to allow depreciation calculated using the book value of a prior owner (rather than the acquisition cost to the taxpayer) where an asset is purchased from a person entitled to a deduction for depreciation for that asset.

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<sup>34</sup> [1968] NZLR 967

## Adjustments on Disposal of Depreciable Assets

Depreciation is an interim allowance in that if the asset is eventually sold for more than its book value, the difference between book value and sale price is brought into income to the extent this results in the recovery of excess depreciation allowed. This is provided for in section 117(1). A proviso to that provision allows any excess depreciation clawed back to be spread over the income year in which the asset is disposed of and the three preceding income years. Where an asset is disposed of without consideration or for less than market value, it is deemed to be disposed of at market value (section 117(5)). Roll-over relief previously applying to assets other than buildings now no longer applies (sections 117(2) and (3)). There is a general exemption for disposals under matrimonial property agreements giving rise to a depreciation clawback (section 117(6A)).

The normal rule is that where an asset is disposed of for less than its book value, and the deficiency can be attributed to fair wear and tear or to the asset becoming obsolete or useless, that deficiency is then deductible in the year of disposal. However, that is not the case with respect to buildings. Section 106(1)(l) denies a deduction for any loss incurred on the demolition or destruction of permanent premises except where any gain on the building would be assessable under sections 65(2)(e) or section 67.

In addition, section 117(1A) prevents a deduction to the extent to which the sale price of the building is below book value. Although that provision is widely drafted, it would seem to relate only to deductions under depreciation provisions and not other provisions of the Act (for example, a deduction for a loss which might be available on a building and for which any gain would be assessable under section 67).

Finally, sections 117(7) and (8) provide for specific rules where insurance is collected on a depreciable asset other than a permanent building. Where insurance receipts are for irreparable damage to the asset, the asset is deemed to be sold for the insurance proceeds. Where the book value is higher than the insurance proceeds, the excess is deductible. Where the insurance receipts are for repairable damage, receipts in excess of the costs of repairs are used:

- to reduce the book value of the asset;
- where this reduces the book value to zero, the asset is deemed to be sold for the amount by which the asset's book value would otherwise be reduced below zero

## ANNEX 2.2

### Trading Stock

The Courts have always required that trading stock be taken into account in the determination of business profits. This is an aspect of the general principle that businesses are not taxed on a cash basis but must also include amounts receivable in their taxable income. For example, in Carden's case<sup>35</sup> it was noted:

"... trade debts which have accrued due in the relevant year but which have not been paid must be included for the purpose of ascertaining whether or not the business has earned a profit for the year, just as stock in trade at the beginning and end of the year must be taken into account for the same purpose".

#### The Statutory Regime for Trading Stock

A specific statutory regime applies to trading stock in New Zealand. This is principally contained in section 85 of the Act. The starting point for a summary of the regime is the definition of "trading stock". That term is defined to include:

- anything produced or manufactured;
- anything acquired or purchased for purposes of manufacture, sale or exchange;
- anything in respect of which expenditure is incurred and which would be trading stock if possession were taken (broadly, goods in transit).

Excluded from the definition of trading stock are land and financial arrangements. Furthermore, it is important to note that the trading stock regime applies only to those taxpayers who own or carry on a business.

Business taxpayers are required to take into account the value of their opening and closing trading stock in the determination of assessable income. Trading stock may be valued, at the option of the taxpayer, at its cost price, market selling value or its replacement price. The opening value of trading stock for any income year must be the same as the value adopted at the end of the preceding year.

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<sup>35</sup> Commissioner of Taxes v Executor Trustee and Agency Co of South Australia Ltd (1938) 63 CLR 108

The regime assesses sales of trading stock and the closing value of trading stock. The opening value of trading stock is deductible. Purchases of trading stock, although not referred to by section 85, are deductible pursuant to section 104. However, the deduction for purchases is effectively deferred until their sale because of the requirement to include closing stock within the taxpayer's assessable income.

In other words, expenditure on purchases which have not been sold by balance date must be "capitalised" until the point of sale. However, the taxpayer can achieve deductions for unrealised losses in respect of trading stock. For example, a deduction for unrealised losses may be achieved by valuing trading stock at market value where this is less than cost price.

### **Consumable Aids**

Consumable aids are distinguished from trading stock. This term refers to those articles or materials which:

- are used in the manufacture or production of goods from which a taxpayer derives assessable income;
- are consumed or become unusable or worthless after being once applied in the manufacturing or production process; and
- do not become component parts of a finished product - i.e., they are not acquired for purposes of manufacture, sale or exchange.<sup>36</sup>

Although consumable aids are not subject to the trading stock regime, section 104A defers a deduction for consumable aids until they are used in the income producing process. However, the Inland Revenue Department has issued a Determination<sup>37</sup> which provides that section 104A will not apply where the unexpired (or unused) portion of accrual expenditure in respect of consumable aids in the possession of the taxpayer at balance date does not exceed \$50,000.

### **Spare Parts**

Spare parts which are not acquired for resale are also to be distinguished from trading stock. Section 104A defers a deduction for expenditure incurred on spare parts until they are used in the income earning process.

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<sup>36</sup> Refer Cunningham and Thompson's "Taxation Laws of New Zealand", 6th Edition 2048, para [206]

<sup>37</sup> Determination E4 of 20 January 1989

## Sale or Disposal of Trading Stock

Under the trading stock tax regime outlined above, the proceeds from the sale of trading stock are included in a taxpayer's assessable income. A number of provisions ensure an equivalent result whenever trading stock is disposed of otherwise than by way of an arms length sale at market value. This includes an exchange, gift, or disposal on death (section 85(8)). Where the consideration is not in cash or is lower than the market value, the trading stock is deemed to be disposed of for market value (section 91(2)). Where a business, including its trading stock, is disposed of, the consideration for the business is apportioned between trading stock and other assets (section 90). Any distribution of trading stock by a company to shareholders is deemed to be a dividend to the extent to which the consideration is for less than market value (section 197(2)).

Where trading stock, consumable aids or spare parts are damaged, lost or stolen, any insurance receipts constitute assessable income under section 79(2). No specific provision is made for the situation where trading stock is transferred to a non-business activity or ceases to be trading stock. English case law<sup>38</sup> suggests that in those circumstances the trading stock is deemed to be disposed of for market value.

There is a general exemption from these provisions for trading stock that is transferred to a spouse under a matrimonial property agreement. Section 91A of the Act allows the transfer to take place without a tax liability being incurred by the transferor.

## Livestock and Bloodstock

In the past, some forms of trading stock have been allowed to be valued at standard values rather than at normal valuations. The standard value system for wine, brandy and whisky (section 87) was removed with effect from the 1989 income year.

The previous standard value scheme for livestock was replaced with a new regime with effect from the 1987 income year (sections 85 to 86H). In very broad terms, this allows sheep, cattle, deer, goats and pigs ("specified livestock"), other than "high-priced" breeding stock, to be valued under one of:

- **a standard value scheme** - where the standard value is the lesser of the declared average market value in that year or 70% of a three year rolling average of market value (section 86);

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<sup>38</sup> Sharkey v Wernher [1953] All ER 493

- **a herd scheme** - which values livestock at its average market value. The result is that the valuation of a herd for tax purposes remains unaffected by changes in the market value of individual units (it is thus a form of inflation-protection), with the valuation changing only in accordance with changes in herd numbers (section 86A); and
- **normal cost/market/replacement value rules** - section 86B.

In most cases, the taxpayer must elect which method livestock is to be valued under one income year and a day prior to the income year in which the election takes effect (section 85A). The herd scheme, if adopted, must be adopted for all livestock of that type.

Non-specified livestock (other than high-priced breeding stock and bloodstock) is subject to the standard value scheme. The cost of high-priced breeding stock is amortised over a deemed useful life (section 86C). The cost of bloodstock is also amortised over a deemed useful life except that there is a market value option where disability of the bloodstock creates a drop of 50% or more in its market value (section 86H).

## ANNEX 2.3

### The Capital/Revenue Distinction

The distinction between items on revenue account and items on capital account runs through much of the Income Tax Act. Nevertheless, it has been a distinction which has been easier to conceptualise than it has been to put into practice. The courts have been forced to draw a distinction that, at least on the revenue side, is divorced from economic reality. As a result, the principles emanating from court decisions can exhibit a high degree of uncertainty and complexity. The way the courts have analysed the issues involved can best be seen by considering the approach adopted with respect to expenditure separately from the approach adopted with respect to income. This is because the courts themselves have had cause to consider these items separately in this context. Moreover, on the expenditure side there is an economic rationale for drawing a capital/revenue distinction. From an economic perspective expenditure on revenue account is expenditure which should be immediately deductible whereas expenditure on capital account should be spread to reflect the economic benefits resulting from the expenditure.

#### Expenditure on Capital Account and Revenue Account

In drawing a distinction between expenditure on capital account and revenue account, an economist would analyse the extent to which the expenditure produces an enduring benefit. The courts have had recourse to a range of generalised principles. Perhaps the most widely used analogy is that of the tree and the fruit. The former is said to represent items on capital account, the latter items on revenue account.<sup>39</sup> While the analogy may have been useful as a general analysis of the distinction, the courts have found it necessary to develop more explicit principles.

One of the earliest examples arose in Vallambrosa Rubber Co Ltd v Farmer.<sup>40</sup> There the court formulated the general principle that a recurring expense implies a cost of ordinary business activity, while a once only payment suggests expenditure on capital account. Lord Dunedin, however, cautioned:

"I do not say that this consideration is absolutely final or determinative; but in a rough way I think it is not a bad criterion of what is capital expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year."

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<sup>39</sup> That analogy was drawn by the Supreme Court of the United States of America in Eisner v Macomber (1919) 252 U.S. 189.

<sup>40</sup> (1910) 5 TC 529



There are many other examples of the courts developing tests to assist in distinguishing expenditure on capital from expenditure on revenue account. The recent decision of the Court of Appeal in CIR v McKenzies NZ Ltd<sup>41</sup> provides a useful summary of the authorities in this area. That judgment placed particular reliance on the tests canvassed by the Privy Council in BP Australia Limited v FCT.<sup>42</sup> In that case, the Judicial Committee was called upon to determine whether expenditure by an oil company for the benefit of petrol retailers was on revenue or capital account. Factors identified as being of relevance in reaching such a determination included:

- the need or occasion that gives rise to the expenditure (expenditure incurred in the ordinary course of the business is likely to indicate expenditure on revenue account);
- the source of the payments - fixed capital is indicative of expenditure on capital account and circulating capital indicative of expenditure on revenue account;
- whether the payments are once and for all or recurring - the former indicates capital account while the latter indicates revenue account;
- a payment bringing into existence an asset of enduring benefit to the taxpayer is likely to be on capital account;
- the treatment of the payment under ordinary principles of commercial accounting; and
- payments relating to the actual business structure of the taxpayer are likely to be on capital account whereas payments relating to the income-earning process are likely to be on revenue account.

The observation of Lord Pearce in the BP Australia decision provides one of the more lucid summaries of the law in this area. He emphasised<sup>43</sup>:

"The solution to the problem is not to be found by any rigid test or description. It has to be derived from many aspects of the whole set of circumstances some of which may point in one direction, some in the other. One consideration may point so clearly that it dominates other and vaguer indications in the contrary direction. It is a common sense appreciation of all the guiding features which must provide the ultimate answer."

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<sup>41</sup> (1988)10 NZTC 5233

<sup>42</sup> [1966] AC 244

<sup>43</sup> at page 264

In general, the courts have tended to view recurrence of expenditure as being a consideration which, if clear enough, will dominate other considerations. Where there is a series of payments which are not properly interpreted as being instalments of a capital sum, then the manner of payment will usually lead to the conclusion that the expenditure is on revenue account. Thus, in Vallambrosa Rubber Co. Ltd. the Lord President stated:<sup>44</sup>

"I think it is not a bad criterion of what is capital expenditure as against what is income expenditure to say that capital expenditure is a thing that is going to be spent once and for all, and income expenditure is a thing that is going to recur every year".

As a result, salaries and wages, for example, are usually regarded as operating expenditures deductible as incurred even where the labour is used to construct or improve a capital asset.<sup>45</sup> Similarly, the costs a business incurs in taking out insurance on its assets will normally be deductible as incurred even though this may be to cover a loss on capital account which if it occurred would be non-deductible.

On occasions it is arguable that the courts may tend to take into account, implicitly if not explicitly, the consequence of holding expenditure to be non-deductible. As previously noted, where it is determined that the expenditure is incurred with respect to an identifiable capital asset, that expenditure may be either deductible on an amortised basis under depreciation rules or, alternatively, a deduction will not be available at any stage. The expenditure will never be deductible where it is incurred for purposes other than producing a depreciable asset - premises, plant, machinery and equipment. There may be some reluctance to accept that expenditure incurred in carrying on a business should never be recognised for income tax purposes where the expenditure results in a real economic loss.

In Vallambrosa Rubber Co. Ltd the court rejected the argument for the Crown that no deduction should be allowed for the costs of weeding and maintaining a rubber plantation because the expense produced assessable income in later income years. The Lord President noted<sup>46</sup> that the Crown's submission would mean that:

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<sup>44</sup> at page 536

<sup>45</sup> It has, however, been held in England that payments to redundant employees of a business which is taken over, where the payments were made by the acquirer of the business and under the takeover contract, can be expenditure on capital account - James Snook & Co v Blasdale (1952) 33 TC 244

<sup>46</sup> At page 535

"if your business is connected with a fruit which is not always ready precisely within the year of assessment you would never be allowed to deduct the necessary expenses without which you could not raise the fruit."

In BP (Australia) Ltd in considering whether payments by an oil wholesaler to oil retailers in order to secure retail outlets should be classified as expenditure on revenue or capital account, Lord Pearce observed<sup>47</sup> that since the expenditure did not give rise to a depreciable asset, the choice was between immediately deductible expenditure or non-deductible capital expenditure. His Lordship noted that "either course presents difficulties, but that an allocation to revenue is slightly preferable".

A factor which it is not appropriate to take into account when determining whether expenditure is on revenue or capital account is whether that expenditure constitutes assessable income in the hands of the recipient or a non-assessable gain. For example, a company may instruct a lawyer to offer advice on raising equity capital. The lawyer's fees would generally be non-deductible capital expenditure of the firm, but assessable income of the lawyer. Similarly, it was held in Trevathan v CIR<sup>48</sup> that the fact that the Income Tax Act brings receipts into income does not mean that any expenditure of the same nature incurred by that taxpayer loses its non-deductible capital nature. Along the same lines, in CIR v McKenzies Ltd<sup>49</sup> the Court of Appeal rejected the view that because the Act specifically made premiums on leases deductible and assessable, payments to acquire a lease were by implication on revenue account and therefore deductible.

### **Income on Capital and Revenue Account**

Although there is no necessary symmetry of treatment between the classification of expenditure as being on revenue or capital account for one taxpayer and the nature of the income in the hands of another recipient taxpayer, nevertheless most of the principles adopted to determine whether particular payments are capital or revenue are also used to determine the nature of receipts. Thus, the relevant factors in determining the appropriate classification of expenditure in BP Australia are also used to determine whether income is assessable or whether it is a non-taxable receipt on capital account.

An important line of cases in this area concerns payments by oil companies to

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<sup>47</sup> At page 627

<sup>48</sup> (1984) 6 NZTC 61,746

<sup>49</sup> (1988) 10 NZTC 5,233

petrol retailers. In CIR v. City Motor Services Ltd; CIR v Napier Motors Ltd,<sup>50</sup> two petrol stations received money from wholesalers, such money being used for improvements to the station premises. While the retailers were not contractually bound to sell the products of the wholesalers making the payments exclusively, it was understood and assumed that they would do so.

It was held that the receipts in question were accretions to the capital assets of the taxpayers which, while they resulted from the fact of carrying on a business, did not arise from the actual operations of that business. Accordingly, the receipts were found to be non-taxable. That illustrates a distinction that has been drawn between the actual capital structure of a business and the ongoing revenue generating process. Receipts associated with the former tend to suggest non-taxable capital receipts, while those associated with the latter category are more likely to be held to be ordinary income. In that regard, the nature of a particular receipt is often determined by the circumstances of the recipient. What is ordinary capital income to one person may well be non-taxable other capital income to another person.

Although receipts not associated with the ongoing revenue generating process are likely to be outside the concept of ordinary income as developed by the courts, it is nevertheless necessary to specify clearly the ambit of that revenue generating process. This is illustrated by a line of cases holding that where the purchase and then sale of assets is an integral part of the overall operation of a business, any profit or gain realised on sale of the assets constitutes ordinary income. An early case in this regard was California Copper Syndicate (Limited and Reduced) v Harris.<sup>51</sup> Briefly, the taxpayer in that case was held to be assessable on the gain from developing and disposing of a mineral mine because the sale of the mine for a gain was, on the facts of the case, held to be an integral part of its business. The conclusion would have been different if the taxpayer had limited its business to mineral mining but then made a gain from the sale of its business asset.

That principle has been applied by the courts to hold that in most cases insurance companies are taxed on gains realised from their investments<sup>52</sup> as are banks.<sup>53</sup> The principle can also apply to investment companies<sup>54</sup> although the extent to which the principle applies is lacking in precise determination. A recent example is the High Court judgment in National Distributors Ltd v. CIR<sup>55</sup> where the question was whether the taxpayer company, the main

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<sup>50</sup> [1969] NZLR 1010

<sup>51</sup> (1904) 5 TC 159

<sup>52</sup> Colonial Mutual Life Assurance Society Ltd. v. FCT (1946) 73 CLR 604

<sup>53</sup> CIR v. Auckland Savings Bank [1971] NZLR 569

<sup>54</sup> London Australia Investment Co. Ltd. v. FCT 77 ATC 4398

<sup>55</sup> (1987) NZTC 6135

purpose of which was real estate investment, was taxable on profits made from investing surplus funds in the sharemarket on the basis that such profits were business income. It was held that the taxpayer was not assessable on sharemarket profits because that was not an integral part of its business. In reaching that conclusion some emphasis was given to the finding that the share investments were not closely monitored but were carried out in a somewhat haphazard manner. The inference is that the Court may have reached a different conclusion if decisions on whether shares should be bought or sold were more clearly based on a coherent pattern and if the investments were more continuously monitored. The finding for the taxpayer was later appealed by the Commissioner of Inland Revenue. The Commissioner successfully argued in the Court of Appeal that some of the share transaction gains were assessable under section 65(2)(e). However, the High Court judgment on business profits was not appealed.

Receipts by way of insurance claims, compensation for damages or a government grant are generally taxed according to whether they fall within the category of receipt on revenue or capital account. The general rule is that such a payment will be on revenue account (and therefore taxable) if it represents a replacement of income or of an asset a deduction for which is allowed on acquisition. Thus, for example, compensation for the loss of trading stock constitutes assessable income. That general rule also finds statutory form in section 79. Where a lump sum payment relates to loss or damage to another asset, the payment would be non-taxable under ordinary rules.

## **ANNEX 2.4**

### **Section 67**

The definition of land for the purposes of section 67 is defined in wide terms to include:

- "Any estate or interest in land, whether legal or equitable, corporeal or incorporeal, freehold or chattel; and
- Any option to acquire land or any such estate or interest in land; - but does not include a mortgage".

This definition embraces buildings so that any profits derived from their sale are subject to the provisions of section 67.

Section 67(4) includes seven paragraphs, each of which brings to tax a different category of land transaction. What follows is a brief summary of each of those paragraphs.

#### **Paragraph (a)**

##### **Land Acquired for Resale**

Paragraph (a) includes within a taxpayer's assessable income profits or gains from the disposition of land acquired for the purpose or intention of resale. The relevant purpose or intention must exist at the date of acquisition of land. Where there are several purposes or intentions in acquiring land one of which was resale, the resulting profits or gains will be assessable.

#### **Paragraph (b)**

##### **Sale of Land by a Dealer or Associated Person**

Paragraph (b) applies where the taxpayer (or an associated person) is considered to be in the business of dealing in land. The paragraph assesses profits or gains derived from land transactions either where the land is acquired for the purposes of the dealing business, or where the land is sold within ten years of its acquisition.

#### **Paragraph (ba)**

##### **Sale of Land by a Developer or Associated Person**

This paragraph applies where the taxpayer (or an associated person) is in the business of developing or dividing land into lots, other than development or subdivisional work of a minor nature. The paragraph assesses profits derived from the sale of land acquired for the purpose of development or division into lots, as well as any land sold within ten years of acquisition by the taxpayer.

### **Paragraph (c)**

#### **Sale of Land by a Builder or Associated Person**

Paragraph (c) of section 67(4) assesses profits or gains derived from the sale of land where the taxpayer (or an associated person) is a builder. Where such a taxpayer undertakes more than minor improvements with respect to the land, whether before or after the land is acquired, profits or gains derived from its sale will be assessable where:

- the land was acquired for the purpose of that building business; or
- the improved land was sold within ten years of its acquisition.

### **Paragraph (d)**

#### **Sale of Land which is Re-zoned**

Paragraph (d) includes within assessable income profits or gains derived from land sold within ten years of acquisition where, in the opinion of the Commissioner of Inland Revenue, at least twenty percent of the profit arose as a result of any of the following factors:

- Any zoning or change of zoning under the Town and Country Planning Act 1953;
- Any consent or decision granted under the Town and Country Planning Act 1953;
- The removal or likelihood of removal of any restriction in relation to the land.

Where a profit is assessable pursuant to this paragraph, section 67(7) permits the taxpayer a deduction of the greater of:

- \$1,000; or
- an amount equal to 10% of the profit for each complete year during which the taxpayer has owned the land.

### **Paragraph (e) - Sale of Land in Scheme of Subdivision or Development**

This paragraph applies where there has been an undertaking or scheme involving the development or division into lots of land within ten years of acquisition. A proviso to the paragraph exempts land sales where the development or division into lots was for the purpose of:

- the carrying on of a business by the taxpayer from the land; or

- the residing of the taxpayer on the land; or
- the deriving by the taxpayer of rental income from the land.

**Paragraph (f) - Sale of Land in Scheme of Subdivision or Development After Ten Years**

This paragraph assesses profits derived from the sale of land that are not otherwise assessable under paragraphs (a) to (e), to the extent that those profits are derived from the carrying on or carrying out of any undertaking or scheme involving the development or division into lots of the land. For the paragraph to apply, the development or division work must involve significant expenditure on earthworks, contouring, levelling, drainage, roading, curbing or channelling or any other work, service or amenity customarily undertaken or provided in major projects involving the development of land for industrial, commercial or residential purposes.

This paragraph is unique in that it assesses only the profit derived as a result of the development project. By comparison, the other paragraphs assess the difference between the sale proceeds and the cost price of the land.

**Exemptions**

Section 67(5) provides an exemption from assessment under paragraphs (a), (b) (ba), and (c) where the land concerned was acquired and occupied by the taxpayer as a private residence, or as business premises from which substantial business was carried on.

Section 67(6) provides an exemption for profits assessed under paragraph (d) where:

- The land was acquired and used, or intended to be used primarily for the purpose of a farming or agricultural business or as a residence or intended residence, and
- The land was sold or disposed of mainly for use on a continuing basis in a farming or agricultural business, or as a residence for the purchaser, and
- In the case of land occupied primarily for the purposes of a farming or agricultural business, the sale was due to circumstances which arose after the land was acquired by the taxpayer.

Finally, sections 67(8) and 67(9) provide exemptions from assessment under paragraphs (e) and (f) where either the land in question was occupied primarily and principally as a residence, or the land sold was used for farming and the



subdivided lots will continue to be used for farming.

### **Associated Persons**

Possibly one of the most significant features of section 67 is that it includes an "associated persons" provision, so that profits derived from land sales may be assessable if the taxpayer is associated with a dealer, developer or builder.

Section 67(2) of the Act defines associated persons to include:

- Any 2 companies that consist of substantially the same shareholders or are under the control of the same persons; or
- Any company and any person (other than a company) where that person or the spouse or any infant child of that person or any trustee for that person or for that spouse or for that infant child hold separately or any 2 or more of them hold, in the aggregate, 25% or more of the paid-up capital or 25% or more in nominal value of the allotted shares of that company; or
- Any 2 persons one of whom is the spouse or infant child of the other person, or is a trustee for that spouse or that infant child; or
- A partnership and any person where that person and any partner in that partnership are, in accordance with this subsection, associated persons".

In very broad terms, two companies will consist of substantially the same shareholders and will be under the control of the same persons where there is 50% common ownership of share capital. The effect of the associated persons concept is that where a taxpayer is associated with a dealer, developer or builder, any land sold by such taxpayers within ten years of acquisition may be included within their assessable income.

## ANNEX 2.5

### The Definition of a Royalty

By virtue of section 2, a royalty is defined to include any payment derived in consideration for:

- the use, or right to use, or supply of any assistance with respect to, or the forbearance from using any:
  - copyright, patent, trademark, design or model, plan, secret formula or process;
  - other like property or right;
  - mine or quarry; or
  - motion picture, television film, or radio tape; or
- the exploitation or right to exploit or the forbearance from exploiting any standing timber or natural resource; and
- the supply, or supply of any assistance with respect to, or forbearance from supplying scientific, technical, industrial, or commercial knowledge or information.

Any such payments are deemed to be a royalty even if paid in a lump sum form, however they are described or computed, and whether or not the payments are an instalment of the purchase price of any real or personal property. Thus, for example, a lump sum payment for the right to extract standing timber falls within the definition of a royalty. The definition is comprehensive enough to cover payments for most forms of intellectual property as well as other payments that would normally be considered to be on capital account. Moreover, the fact that a payment otherwise on capital account is taxable as a royalty does not necessarily obviate the possibility that it may still be non-deductible as expenditure on capital account.

## ANNEX 2.6

### The Accrual Rules

The accrual rules apply to "financial arrangements", a term that is widely defined to include virtually every arrangement where there is a deferral of the passing of any benefit unless the arrangement is specifically excepted. (Arrangements which are specifically excepted include shares, insurance contracts and various short-term purchase agreements.) The rules therefore extend beyond financial instruments and apply to arrangements with similar effect. For example, an agreement or option over property is prima facie included within the ambit of the rules.

Income or expenditure under a financial arrangement is calculated as the difference between the benefits received under the arrangement and the benefits provided, with all benefits converted into a monetary equivalent. A net benefit received by a taxpayer is income; a net benefit provided is expenditure. Income is assessable under section 65(2)(jb). Expenditure is, in most cases, automatically deductible for holders of a financial arrangement (generally the equivalent of the person lending funds) and deductible under normal rules as interest expenditure for other taxpayers.

The general rule is that income and expenditure that is reasonably anticipated at the time the arrangement was entered into is recognised on a yield-to-maturity basis so as to be evenly spread throughout the term of the arrangement. Gains and losses on the arrangement that are non-systematic and not reasonably anticipated at the time the arrangement is entered into are generally recognised when the arrangement matures or the taxpayer disposes of its interest in the arrangement. For example, any premium or discount on a debt instrument is spread on a yield-to-maturity basis over the term of the instrument, whereas any gain or loss from holding that instrument resulting from a fall or rise in market interest rates is recognised only when and if that gain or loss is realised. These recognition rules are a marked departure from ordinary rules, which recognise income when it is realised and expenditure when it has come home to the taxpayer.

There are a number of exceptions to the accrual timing of recognition rules. They do not apply to natural persons holding financial arrangements to a total value below a certain threshold. For such people, gains and losses are recognised under ordinary rules or when realised. On the other hand, unanticipated gains and losses resulting from fluctuations in foreign exchange rates are recognised on a full accruals basis, rather than when realised. Some taxpayers (for example, taxpayers in the business of dealing in financial arrangements) may recognise all gains and losses resulting from changes in the market values of instruments, including unanticipated gains and losses.

In general, the accrual rules ignore the capital/revenue distinction. All gains and losses under a financial arrangement are usually accounted for even if such gains or losses would normally be considered to be on capital account. Again, however, there are exceptions. Any gain or loss on an agreement for the sale and purchase of, or option over, property that results from fluctuations in the value of the underlying property is generally excluded from accrual income or expenditure. Any such gain or loss will be taxable or not taxable according to the taxpayer in question and to the appropriate rules governing gains and losses made on the property.

The clearest example of retention of the capital/revenue distinction under the accrual rules applies with respect to bad debts. Prior to the enactment of the accrual rules, the deductibility of bad debts in respect of financial instruments was governed by the traditional capital/revenue distinction and section 106(1)(b) of the Act. This meant that no deduction was allowed for a bad debt which constituted a "capital loss". A bad debt was a capital loss if the loan was on capital rather than revenue account. Thus, moneylenders could claim a deduction for bad debts, as could those who provided trade credits as part of their business operations. Section 106(1)(b) permitted a bad debt deduction in the year the debt was actually written off.

New bad debt provisions now apply to financial arrangements under the accrual rules. Section 106(1)(b) has been retained, but it has been supplemented by new rules set out in section 64G. The Consultative Committee stated that the new rules aimed to provide a regime that met the technical requirements of the accrual rules but was consistent with previous law both as to the requirements set out in section 106(1)(b) and under the capital/revenue distinction.

Section 64G(1) in effect allows a bad debt deduction, subject to section 106(1)(b), for loans on revenue account. However, the deduction is limited to the amount which has already been brought to tax as income under other accrual provisions. Section 64G(2) allows, again subject to section 106(1)(b), a bad debt deduction for a greater amount, but the intention was to limit that deduction to loans on capital account. This was achieved by limiting the application of section 64G(2) to persons in the business of holding or dealing in financial arrangements of the type for which a bad debt deduction is allowed.

This may be more restrictive than the previous rules because persons not in the business of holding or dealing in financial arrangements could nevertheless have loans on revenue account. For example, this could be the case where a business provides trade credits. The above assumes that section 64G restricts section 106(1)(b).

Perhaps the main exemption from the accrual rules with respect to timing and the removal of the capital/revenue distinction is an exemption for non-residents to the extent that they do not carry on a business through a fixed

establishment in New Zealand. Such non-residents continue to calculate income and expenditure under the prior rules, including the capital/revenue distinction where it continues to apply and the ordinary derived/incurred tests. The tax position of non-residents is also, of course, subject to any available double tax treaty relief.



# CHAPTER 3: PROBLEMS WITH CURRENT TREATMENT

## 3.1 Introduction

Chapter 2 provided an outline of the main features of the treatment of income from capital under existing New Zealand tax law. In doing so, it became apparent that there a number of problems with those rules.

A dominant feature of current tax law is that it results in a considerable divergence between income as measured for tax purposes and actual income. The main contributing factors to this divergence between actual and taxable income, which were identified in Chapter 2, are the exemption from tax of certain forms of income on capital account and the failure of the tax system to adjust income for the effects of inflation. This chapter explores these matters further. It does so by considering in more detail deficiencies in the present tax regime, highlighting the extent to which those deficiencies undermine the fairness of the tax system, increase economic costs, and create administrative and compliance difficulties.

Taxation reform is an on-going process. The chapter does not purport to be a comprehensive catalogue of all remaining taxation problems. It identifies problems additional to those raised in Chapter 2 but focuses on issues which are more critical if a closer alignment between taxable income and actual income is to be achieved.

Section 3.2 briefly summarises the major taxation exemptions currently applying to forms of income from capital. The economic, equity and administrative consequences for the income tax system of those exemptions are examined in section 3.3. In addition to exempting some types of income on capital account, the present regime exempts a major class of income that may be termed "non-market" income. Broadly, this is income that is not derived from market transactions and hence is generally not specified in money or a monetary equivalent. The consequences of exempting this form of income are discussed in section 3.4.

Section 3.5 deals with the failure of the income tax system to account for inflation. The section discusses the consequences of having no inflation adjustment and illustrates the impact of inflation on different types of capital income.

Section 3.6 discusses problems associated with the rules on the timing of recognition of capital income and expenditure as well as specific problems with the present treatment of trading stock. It also discusses some restrictive provisions which wider reforms could allow to be relaxed. Finally, Section 3.7 offers concluding comments.

## 3.2 Exemptions for Market Income

A market activity is an activity that involves the buying or selling of goods or services for money (or its equivalent). Market income is the monetary income a person derives from such an activity. It was noted in Chapter 2 that many forms of market income remain untaxed despite the extension over the years of what constitutes taxable income. One of the central concerns of this Document is whether it would be desirable to remove these exemptions. This section outlines the types of exemptions which the Document is concerned with.

These exemptions fall under the broad heading of income that has not been taxed because it is derived on capital account. This includes all presently untaxed profits made from disposing of assets. Thus, the types of currently untaxed income identified in section 2.5 of the previous chapter fall within this exemption category. Those were:

- income from profits on the disposal of land, shares, and other "investment" assets;
- income from goodwill payments and other profits from the sale of a business or activity; and
- other income on capital account, such as payments under restrictive covenants.

These are the types of income that would be taxable if the exemption for income on capital account were removed.

Receipts that may not be taxable under current law but that do not form part of the exemption for market income include the following:

- income specifically exempted from tax for policy reasons (such as income derived by charities and other exempt persons);
- gifts, bequests and legacies - though they may constitute a disposal giving rise to the recognition of accrued income in the hands of the donor, as outlined in Chapter 15;
- the proceeds from insurance policies, subject to their not being a payment under a deemed disposal (as outlined in Chapter 15). Thus, for example, a presently exempt payment under a life insurance policy is not considered income benefiting from the exemption discussed in this Document; and
- currently untaxed gambling and similar windfall gains.

The tax treatment of these types of gain or receipt are not considered further in this Document.



### **3.3 Effect of Exempting Some Forms of Capital Income**

This section outlines some of the consequences for efficiency, fairness, and compliance costs of the exemption for income on capital account outlined in the previous section. The exemption results in a tax system that:

- imposes unnecessarily high economic costs on the community;
- enables many people to structure their investments to escape the full share of tax that the legislature intended to impose on those transactions;
- is unfair in the sense that it imposes tax on some forms of income and not others and is perceived to be particularly unfair in that it tends to tax at zero or low rates income derived by higher-income taxpayers; and
- incurs high administrative and compliance costs because of the difficulties of determining what income is taxed and what income is not taxed.

#### **3.3.1 How Capital Income Exemptions Impose Economic Costs That Reduce National Welfare**

Holes in the income tax base result in some forms of income and expenditure being favoured by the tax system relative to others. At the same time, other forms of income and expenditure are relatively penally taxed.

As outlined in Chapter 1, the tax-favoured forms of investment become more attractive to taxpayers and investment in those forms increases as a result. On the other hand, penally-taxed forms of investment become less attractive and investment in those forms can be expected to decline relative to the position where all activities are taxed in a like and appropriate manner.

Any such change in investment patterns is purely the product of the tax system. In the absence of taxes, the return from any given investment would be determined by non-tax factors. If taxes are introduced but concessions are provided to one activity, the after-tax return from that activity becomes relatively more attractive, thereby increasing the amount invested in the activity. While it is the after-tax return that influences taxpayers in their investment decisions, it is the pre-tax return that determines the overall benefit to society of a particular investment.

Thus, a tax system that disrupts the relative rates of return between different investments and activities (imposing penalties on some and providing concessions to others) diverts investment away from forms and areas producing the highest possible returns to society. In other words, under such a tax

system, private individuals and organisations no longer make business decisions that are in the best interests both of themselves and the overall well-being of society.

The exemptions from tax discussed section 3.2 can be expected to have distorted taxpayer behaviour in a number of ways. The exemptions could be expected to encourage investment in capital intensive activities relative to labour intensive activities. They could be expected to divert investment from assets producing relatively highly-taxed income to assets producing relatively lowly-taxed income. Finally, the exemptions could be expected to change the form in which investment takes place.

The exemptions, by themselves, would result in a general under-taxation of capital income. Other forms of income are generally more comprehensively taxed. For example, it is difficult for the average wage and salary earners to escape tax being levied on all of the employment income they derive. Very broadly, the Income Tax Act operates by partitioning employment income into two categories. Remuneration in cash, or which is convertible into cash, is taxable as monetary remuneration. The term "monetary remuneration" is very broadly defined to include all monetary benefits flowing from an employment relationship and most forms of payment that an employer makes to reduce the costs of expenditure incurred or to be incurred by an employee.

The most common form of benefit not taxed as monetary remuneration is an in-kind benefit that is not convertible into money. Such benefits are generally taxed under the fringe benefit tax provisions of the Act. Thus, the scheme of the Act is to bring all forms of employee remuneration to tax as either income of the employee or as a fringe benefit. Outside the special area of restrictive covenants and inducement payments, there is little opportunity for remuneration to be provided in a form that escapes taxation.

The comprehensive treatment of income from employment contrasts with the tax treatment of capital income. As previously discussed, in the latter area taxpayers have considerable scope for deriving income that is not taxable.

This conclusion is subject to the caveat that there can be deferral of taxation that occurs when people invest in their own productive potential and where employers invest in staff productivity. Investments made for the purpose of improving future earning capacity are not subject to tax until that investment is realised by way of higher current income. Thus, the current tax system is particularly unfavourable with respect to the employment of less-skilled and part-time workers.

The lack of comprehensive taxation of capital income also inflicts detrimental changes on the the type of investments people make. As previously noted, rational investors will attempt to maximise their post-tax return from their investments. They are therefore encouraged to invest in lowly-taxed areas,

irrespective of the fact that such investment may overall produce a relatively low return to the community as a whole. For example, to the extent to which untaxed gains can be made out of investing in firm "goodwill" and brandnames, the tax system provides an incentive for such investment to the detriment of other, potentially more productive but more highly-taxed, opportunities. Hence, the current tax system is likely to be encouraging the excessive use of advertising. For the same reason, small businesses are encouraged to spend more time than would otherwise be justified on public relations rather than on producing goods and services.

Finally, the current tax system may favour one organisational form over another. Again, where the less efficient form is used for tax reasons, the result is an economic cost that society as a whole bears by way of reduced national output.

The point can be illustrated by examples from two areas. First, where capital income is derived by a company, to the extent that any tax exemption is clawed back on distribution to shareholders in the manner described in Chapter 2, undertaking investments or a business through a company is penalised. In such cases, people pay less tax on the same investment or business by investing or carrying on the business directly. This type of tax penalty could be reduced by either enabling companies to make untaxed distributions or by making the tax base more comprehensive for everyone, irrespective of whether they are individual investors or business people or companies. The first option was rejected at the time of implementation of full imputation because it was seen as allowing too great an opportunity for taxpayers to structure their affairs to escape the full tax impost Parliament intended. The second option is clearly preferable.

A second example of how exemptions for certain forms of capital income can distort the form or manner in which investments are made is illustrated by the line of cases (discussed in Annex 2.3) suggesting that the more particular and thorough an investor is in its investment strategy, the greater its exposure to tax on any gains made on those investments. In other words, the current tax system may favour poor investment strategies over good investment strategies. This would have a detrimental impact on the overall performance of the economy.

The same line of cases holds that insurance companies and similar financial institutions are generally taxable on investment gains that, if made by a different entity, might be considered non-taxable receipts on capital account. Again, the principle is discriminatory. It penalises investments through such entities relative to investments carried out in another form.

### 3.3.2 How Capital Income Exemptions Enable People to Escape Income Tax Normally Payable

The fact that current rules do not bring to tax all forms of capital income obviously means that people can derive such income without a tax impost. Beyond that, taxpayers who derive income which would not normally qualify for the exemption can restructure their affairs to bring the income into the exempt category. As a result, any hole in the income tax system results not only in no tax being imposed on the exempt income, but it also results in any such hole being exploited by taxpayers wanting to escape tax on income not intended to be exempt. Because of this tendency, the revenue loss from any tax exemption is usually greater than it might appear when first examined.

Any exemption for income on capital account is particularly exploitable as a means of escaping tax on other income. This is because of the relative ease by which income on revenue account can be recharacterised as income on capital account. As noted in Chapter 2, a consequence of this possible recharacterisation has been that Parliament has, over time, found it necessary to broaden the definition of assessable income to include many forms of income which would otherwise be considered to be non-taxable income on capital account. This is particularly true with respect to income from investments in land and buildings, financial arrangements and intellectual property.

Nevertheless, as also noted in Chapter 2, major holes remain that taxpayers can often exploit to reduce their tax. For example, a taxpayer may be able to arrange his or her affairs so that a payment that is in reality for personal services can be made as a payment relating to a restrictive covenant. To the extent to which the payment can legitimately be argued to relate to the restrictive covenant, it can be asserted that it is free of tax. If the same payment were made directly for personal services, it would be taxable as ordinary income. Similarly, businesses can sometimes arrange for payments to be received which are outside the current operations of the business and thus non-taxable. Such a payment can be in partial or even full substitution for contractual payments that would otherwise be received on a regular basis and that would be assessable income.

The examples illustrate a general principle - that otherwise assessable income can be transformed into non-taxable income on capital account if it is possible to derive income by way of a sale of an identifiable asset rather than as a payment for a good or service that is provided as part of one's ordinary income generating activity. Often the easiest way of achieving this result is to create the required asset by way of a company that is then sold for a non-taxable profit. For example, a person may have developed a new technique for supplying services to a client that reduces the cost of production. Assuming the services can still be supplied at the old rate, one option would be to increase

the profit on the supply of services. That increased profit would normally be fully taxable. To escape tax on that income, another option could be to have the new technique owned by a separate company, and then sell the company to the client for a profit. The result would ordinarily be to turn assessable income into a non-taxable profit.

The ability to achieve such a result in normal business dealings is often constrained by commercial considerations and by the difficulty of ensuring that the payments remain deductible to the party making the payment.

With respect to the need for the payer to receive a deduction, there is no necessary symmetry in this area between assessability and deductibility. Although income may be non-taxable to the recipient, for whom it is on capital account, that does not mean that the same payment is not deductible expenditure on revenue account for the payer. This point is illustrated by the examples given in Chapter 2 of payments by petrol wholesalers to petrol retailers. Different factors were considered relevant in holding that payments were deductible from the factors considered in determining that payments were non-taxable.

The result is that any exemption from income tax, including the exemption of income on capital account creates significant opportunities for taxpayers to exploit the exemption in unintended ways, with a resulting depletion of the income tax base. It is sometimes suggested that that problem could be dealt with by the use of anti-avoidance provisions: either provisions specific to the problem, or more general anti-avoidance law. However, general anti-avoidance provisions, such as the existing section 99, are difficult to interpret and operate in a manner that provides taxpayers with reasonable certainty as to their tax position and that is seen as being fair both to the revenue and the taxpayer. Such measures have an inherent interpretative difficulty. If a taxpayer structures its affairs to derive income that is not subject to tax, one argument is that the taxpayer cannot be said to have avoided tax because no tax was payable in the first place. If that interpretative approach were adopted, general anti-avoidance provisions would be in danger of losing all effect. This would clearly be contrary to parliamentary intent.

More specific anti-avoidance measures can be easier to interpret and can provide taxpayers with greater certainty about the taxation consequences of particular transactions. An example of a specific anti-avoidance provision was section 26AAA of the Australian Income Tax Assessment Act 1936. This section taxed profits or gains from the purchase and sale of most property if the re-sale took place within 12 months of the purchase of the property. However, the section did not affect property held for more than 12 months. This illustrates the problem with specific anti-avoidance measures. In order to be specific enough to provide taxpayers with reasonable certainty as to their position, such measures inevitably turn out to be specific enough to be circumvented by moving just outside their ambit.

This problem was demonstrated in Chapter 2, where it was argued that specific measures such as section 67 (bringing profits and gains on various land transactions to tax) were weakened by the ability of taxpayers to move just outside the effective range of the section. Thus, a transaction involving land that could give rise to a tax liability can often be restructured as a transaction involving a company that owns land. This is the inherent problem when the tax base is widened by a slight alteration in the boundary between what is taxable and what is not. The problems occurring at the old boundary re-emerge at the new boundary.

Another approach which has been adopted in the past is to deny deductions that should generally be available in cases where income that should be taxed is not taxed. The legislative response is sometimes to restrict the deductibility of losses from certain activities or, more specifically, to disallow the deduction of interest. This was the sort of rationale underlying the enactment of sections 129 and 188A of the Act.

There are a number of difficulties with such approaches. First, the alleged abuse needs to be identified and described in statutory terms. Secondly, the approach attacks the wrong target. The interest or other costs should be deductible, it is the non-taxation of income that is the problem, not the allowance of a deduction for legitimate expenditure. Little is achieved by allowing those who are able to finance an investment from their own resources to derive tax-free gains, but not those who must borrow funds to do so. Thirdly, the ad-hoc and specific nature of such measures normally means that a person can restructure his or her affairs and escape any adverse impact. This has been the case with sections 129 and 188A. For these reasons, this type of approach is usually seen as distortionary, unfair and unworkable.

The best approach is generally to move on a broader basis to a more comprehensive taxation of all forms of income. To the extent to which policy considerations lead to the view that certain forms of income should remain exempt, it is generally preferable for such exemptions to be provided for specifically in the legislation. This provides a mechanism by which it is at least easier for the revenue authorities to try to ensure that the exemption is limited as far as possible to the areas that Parliament originally intended.

### **3.3.3 How Capital Income Exemptions Make the Tax System Unfair**

It was argued in Chapter 1 that a perception of unfairness can be destructive of the workings of the income tax system. An essential ingredient of any tax system operating largely on the basis of voluntary compliance is that it must be seen to be fair. Any taxation exemption is likely to be seen to result in inequities unless those who derive exempt income are believed to have strong equitable grounds for enjoying the exemption. Thus, people may not object on equity grounds to a taxation exemption for worthy charities, but the tax system

will tend to fall into disrepute if the rich and well-off appear to be benefiting from a tax exemption that is less available to ordinary people.

In the context of an unindexed tax system, it is likely that most people do benefit to some minor extent from the exemption for income on capital account. Most New Zealand adults are homeowners. To the extent that homeowners derive tax-free capital income from accretions in the value of homes, they benefit from the exemption. However, if capital income is measured in inflation-adjusted terms, the amount of income derived from increases in the value of homes would usually decline to a negligible amount.

For ordinary people, their main source of income is salaries and wages. As noted in section 3.3.1, employee remuneration is one of the more comprehensively taxed forms of income. It is taxed as either monetary remuneration or under the fringe benefit tax provisions. There is very little scope for employees to transform such income into untaxed income on capital account. Another significant form of income for the ordinary person is interest on savings. Again this form of income is relatively comprehensively taxed under ordinary principles as enlarged by the accrual rules. Indeed, in inflation-adjusted terms, such income is generally over-taxed.

Since ordinary people have little opportunity to earn untaxed capital income, the exemption can be seen as a prerogative of the wealthy. Moreover, since the same people have greater flexibility in determining the form in which they derive income, and the resources to provide them with greater access to expert taxation advice, the wealthy have a much greater opportunity to exploit holes in the tax base by diverting otherwise assessable income into a non-taxable form along the lines previously discussed.

This conclusion is supported by overseas experience. Data from Australia, Canada and the United States of America show that a disproportionate share of tax collected under capital gains tax regimes is collected from upper income earners. The top 10% of income earners (as measured for tax purposes) in all three countries derived 50% of the income under their respective capital gains tax regimes. By comparison, that group derived only about 20% of wage and salary income. In Australia, the top 2% of income earners derived 45% of income assessed under the capital gain provisions and only 4% of wage and salary income.

This data is obviously dependent on the the particularities of the various income tax regimes. However, it is consistent across different regimes. It is also to be noted that studies in the United States indicate that inflation-adjusted capital gains are more highly concentrated in the top income bracket than are nominal gains.

There is no corresponding data available on the distribution of currently non-taxable capital income in New Zealand. However, based on overseas data it is estimated that the top 1% of taxpayers realise between 17% and 24% of nominal capital gains.

The data on which the above comments are made are presented and discussed in more detail in Annex 3.1.

The result is that the direct beneficiaries of the current exemption for capital income are the richer sections of society. Most people may benefit from the exemption to a small extent, but it is the rich who benefit the most. Thus, in most cases all but the highest-income earners should pay less tax if the exemption did not exist, even taking into account the fact that removal of the exemptions would apply to everyone. As previously noted, the Government may wish to exempt certain forms of income from tax. On equity grounds, however, it is hard to justify an exemption of which the rich are the direct beneficiaries. It is difficult to believe that a government would explicitly legislate for such an exemption. The exemption has been accepted in the past simply because it is implicit and therefore not measured and not recognised for what it is.

It was reasons along the lines outlined above that led the 1988 Royal Commission on Social Policy to conclude that, in terms of fairness alone, the argument for removal of the remaining exemption for income derived on capital account was overwhelming. The Royal Commission also considered that the exemption should be removed on economic efficiency grounds.<sup>56</sup> Removal of the exemptions would not amount to a tax aimed at the wealthy. Rather, it should be seen as the removal of an exemption currently disproportionately enjoyed by the wealthy - an exemption that does not appear to meet any of the equity criteria that New Zealand as a society generally upholds.

### **3.3.4 How Capital Income Exemptions Increase the Complexity of the Tax System**

The 1982 (McCaw) Task Force on Tax Reform noted that, in principle, there is no reason to continue to exempt income on capital account. It conceded that there were good arguments for removing the exemption on equity if not efficiency grounds. Nevertheless, it recommended against such reform largely on the grounds that it would introduce substantial complexity into the income tax system.

It is valid to question the merits of a reform that would add to the complexity of the tax system. On the other hand, it should be borne in mind that the simplest tax system is one that levies no tax. Although simplicity considerations are important, in general simplicity is relevant in considering the manner in which forms of income should be taxed rather than whether or

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<sup>56</sup> Report of the Royal Commission on Social Policy, April 1988, Volume III, Part 2, page 451



not they should be taxed at all. As noted in Chapter 1, the question is really one of striking the correct balance between simplicity, equity and efficiency considerations. If the case for removing the exemption is sustainable on equity and efficiency grounds, it should be possible to design a practical method of taxing presently untaxed capital income that meets compliance and administrative concerns.

Some of the problems with administering the present Act are attributable to the exemption for forms of capital income and the continued use of the capital/revenue distinction. Thus, removal of the exemption would in some respects simplify the system. This point was stressed by the 1988 Royal Commission on Social Policy. In reaching an opposite conclusion to the McCaw Task Force on the desirability of capital income reform, the Royal Commission noted the complexity and compliance costs that the exemption for certain income on capital account imposes. Commenting on the capital/revenue distinction, the Commission noted that it "is often elusive or unreal and it has given rise to an immense amount of litigation".<sup>57</sup>

The difficulties that the Courts have experienced in drawing this distinction were noted in Chapter 2. As noted by the Royal Commission, the result is a system that has been profitable for litigation lawyers but costly for taxpayers and the revenue authorities as well as creating long delays until a taxpayer's assessable income is finally determined. Only a very small minority of instances where there is doubt as to the capital/revenue boundary ever actually go to court. Thus, the costs in terms of uncertainty and complexity caused by the distinction are grossly under-estimated by considering only actual court cases.

Given that the distinction, in the words of one judge, "runs all through the law of income tax", the uncertainties created makes it difficult for taxpayers to comply with the law without expensive advice, makes it difficult for taxpayers to be sure of the taxation consequences of investment and other decisions and places a heavy burden on the Inland Revenue Department in enforcing the law. An example is the conflicting views surrounding the current tax treatment of investment entities such as unit trusts and superannuation schemes and whether such entities are liable to tax on realised investment gains as ordinary income.

As well as the complexity surrounding where to draw the capital/revenue line, additional complexity is added to the tax system by the provisions (outlined in section 2.4) that were enacted specifically to modify the distinction. Those measures are themselves often complex and involve additional subtle

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<sup>57</sup> Report of the Royal Commission on Social Policy, April 1988, Volume III, Part 2, page 450

distinctions. This is demonstrated by reviewing the various provisions in section 67, outlined in Annex 2.4. Again, the ability of the taxpayer to easily comply with legislative requirements and the ability of the Inland Revenue Department to enforce compliance are undermined.

Against these factors would be the additional compliance costs taxpayers would face from having to calculate income which is currently not taxed. Nevertheless, that should not be overly burdensome provided the tax base is widened in a reasonable and practical manner.

### **3.3.5 Conclusion - Effect of Exempting From Tax Specific Forms of Capital Income**

Any aspect of the tax system and any tax reform should be judged on the extent to which it meets the normal criteria of minimising the economic costs incurred from raising taxes, improving the fairness of the tax system and minimising complexity and administrative and compliance costs of collection. The above review suggests that the general exemption for income on capital account meets none of those criteria. It is an exemption that distorts investment decisions to the detriment of overall national welfare, that is enjoyed to a disproportionate extent by wealthier taxpayers, and that creates complexity.

Removal of the exemption would result in a tax system that better met normal criteria of a good tax system and that was less open to abuse. Put in another way, it is difficult to believe that anyone could sustain an argument for introducing such an exemption if it were not already in place.

## **3.4 Exemption of Non-Market Income**

A non-market activity means an activity that does not involve the buying or selling of goods or services for money (or money's worth). Non-market income is the non-monetary income a person derives from a non-market activity. An example of a non-market activity is a hobby such as gardening or a sport. The hobbyist derives psychic income (i.e., satisfaction or enjoyment) from his or her hobby. This income would be very difficult to measure and for this reason, and others, such income is not taxed. The compliance and administrative difficulties are so high that this is an instance where it is generally better to exempt the income than to attempt to tax it.

The exemption does, however, incur an economic cost. When the hobbyist works for wages or a salary, his or her wage or salary income is taxed. Because an income tax reduces the return to the taxpayer from market activities relative to the untaxed return available on non-market activities, it discourages the former and favours the latter.

It is obvious that there is a wide range of sources of non-market income. The most important source of such income (apart, perhaps, from the non-monetary income produced by human capital) is the income derived from the ownership of physical assets such as houses, cars and household durables.

### 3.4.1 Owner-Occupied Houses

When a person owns a house and lives in it, he or she receives a non-monetary return consisting of the accommodation and other services (such as the enjoyment of a garden or a view) resulting from occupation of the house. The market value of this non-monetary income is the rent that the person would obtain if the house were let out. This market value may be more or less than the value to the owner of the occupation of the house. For example, the owner may place an unusually high value on some feature of the house. In effect, the owner is renting the house to him- or herself for a rental equal to the market rental.

The non-monetary income derived from home ownership is usually referred to as "imputed" rental income. Though the income is not actually received as money, it is of real benefit to the home owner in that it eliminates the need for the owner to pay rent to someone else. Rent paid to another person would have to be paid out of post-tax income. For example, if a person on the 24% tax rate has to pay \$100 a week in rent, he or she must earn \$131.60 before tax each week in order to pay the rent. A home owner living in a house that could be rented out for \$100 a week therefore derives imputed rental income before tax of \$131.60 a week.

Since this imputed income is not taxed, there is an obvious tax advantage in owning a house. Much of this advantage will, however, have long since been capitalised into house prices. That is, house prices will have risen to reflect the tax advantages of home ownership. In response, more investment in new houses will have taken place than would have been the case in the absence of the tax benefit. The resulting demand for inputs into housing, such as, land timber and skilled labour, will have pushed up the prices of such inputs.

One result of the tax benefit of home ownership having been capitalised into the cost of houses is that people are often surprised to find themselves better off renting than buying and paying mortgage interest.

The increased stock of houses as a result of the present tax benefit will have reduced the return on further investment in housing. Eventually a point will have been reached where the expected post-tax return from such investment is no higher than that available on other investments. In aggregate, however, society has more of its wealth invested in housing than it would under a

neutral income tax system. Investment in assets that produce a higher rate of return before tax than owner-occupied housing is displaced by investment in the latter. Hence, society's aggregate income is lower than it would otherwise be.

### **3.4.2 Other Personal Assets**

A similar situation applies to other personal assets such as cars and household durables (e.g., televisions and fridges). In each case, the imputed income produced by the asset is the rental income the owner would have to pay if the asset were rented rather than owned. Since this income is not taxed, these assets are more expensive than they would be under a neutral tax regime.

## **3.5 Impact of Inflation**

### **3.5.1 Introduction**

As stated in chapter 2, the present tax system takes no account of the effect of inflation. The impact of inflation can be illustrated by considering a simple asset such as a bank deposit.

Ignoring a number of complications for the moment, assume that a person invests \$1000 in a term deposit for 12 months at an interest rate of 10%, with interest payable at the end of the term. At the end of the 12 month period, the person would have earned \$100 in interest. If the interest were taxed at 24%, the person would earn \$76 after tax (or \$67 if the interest were subject to the 33% tax rate). Suppose that the inflation rate over the 12 month period turned out to be 6%. The principal of \$1000 repayable at the end of the 12 months would therefore buy less than at the beginning of the term. Its "purchasing power" or "real" value would have fallen by the rate of inflation. Thus, the first \$60 of the \$100 of interest is merely compensation for the loss of purchasing power of the money invested. Yet the tax system treats the whole of the nominal interest of \$100 as income. If the real interest only were taxed, the person would pay tax on \$40. At a tax rate of 24%, the tax payable would be \$9.60 instead of the \$24 payable when the full \$100 of interest is taxed.

The following sections consider the impact of inflation on the taxation of capital income in more detail and discuss a number of complications that were ignored in the above example. It is useful to deal first with real assets before returning to financial assets, such as debt instruments, and to separate the treatment of real assets from the way in which they are financed.

### **3.5.2 Property That Produces Taxable Income on Disposal**

The simplest assets to analyse are those that produce income which is taxable when the asset is sold. Examples include property that is subject to section 65(2)(e) and land that is subject to section 67. (Financial assets that are included within the definition of a "financial arrangement" in section 64B are

not included in this section. They are considered below along with other types of debt instrument).

The net taxable income on this class of asset is taken to be the difference between the sale price of the asset and its cost. For present purposes, expenses such as selling costs can be ignored. Alternatively, the sale price can be considered to be the sale price less the cost of selling the asset. Such a gain is assumed to be taxable in the year in which the asset is sold.

The price (or value) of an asset will usually increase over time because of inflation. Thus, part of the income realised on sale is simply an inflationary gain. Because the whole of the income is assessable, the inflationary component is taxed. If the asset increases in value in real terms (i.e., after taking into account inflation), the real income is also assessable on sale.

At first sight, it might appear that the longer an asset has been held, and hence the greater the inflationary gain, the more adverse will be the effect of inflation on the owner's tax liability on sale. In fact, as illustrated in Annex 3.2, the converse is true. The longer the asset is held before sale, the lower the effective tax rate on the income on sale.

This is best understood by first considering the situation when there is no inflation. Assume, as in Annex 3.2, that an asset is purchased for \$1000. In the absence of inflation, it will have increased in value to \$1100 after one year and \$1210 after two years, assuming a 10% per annum real rate of increase in value. If the asset were sold at the end of the two year period, the gain of \$210 would be assessable. If the tax rate were 33%, the tax payable would be \$69.30. The taxpayer would be left with \$1140.70 after tax.

Compare this with the result when the asset produces the same pre-tax rate of return of 10% per annum but all of the resulting income is taxed each year. The owner would have income of \$100 in the first year. After tax of \$33, there would be \$1067 to reinvest. If this were reinvested at a pre-tax rate of return of 10% per annum, the owner would earn \$106.70 before tax. Following the payment of tax of 33% of this amount (i.e., \$35.21), the owner would be left with \$1138.49. This is \$2.21 less than in the first case outlined above.

Thus, of the two assets, it is clearly better to hold the first one. In the second case, the taxpayer must pay tax at the end of the first year. This tax is not paid in the first case. In effect, the unpaid tax is reinvested, thus generating additional income, which is not obtainable in the second case. (The tax payable at the end of the first year was \$33. If this amount were invested at 10% per annum for one year, it would generate income of \$3.30. If this were taxed at 33%, the tax payable would be \$1.09. The amount remaining after tax would therefore be \$2.21. This is the extra amount earned in holding the first asset rather than the second.)

The results become more extreme for assets held for longer periods. For example, if the exempt asset were held for, say, 10 years, the pre-tax gain would be \$1593.74, the tax payable \$525.94 and the post-tax proceeds \$2067.81. After the same period, the owner of the second, fully-taxed asset would have accumulated \$1912.69 after tax. This is \$155.12 less than the owner of the first asset. After 20 years, the difference would be \$1,179.04 and after 30 years, \$5,023.67. Thus, the divergence between the returns on the two investments increases disproportionately over time. It is clear that it is more advantageous to own the first type of asset than the second. In practice, this difference would certainly be reflected in the prices of the assets - the first asset would be worth more than the second at the beginning of the period. This effect has been ignored to illustrate the difference between taxing on realisation and taxing on accrual.

These differences in tax treatment can be summarised in the effective tax rates applying to the investment. In the case of the first asset, where income is taxable only on sale, the effective tax rate on the real income, as illustrated in Annex 3.2, decreases from 33% when the asset is sold in year 1, to 29% in year 5, 25% in year 10, 18% in year 20 and 13.6% in year 30. Thus, the first result to note is that the tax impost on income which is taxed only on realisation decreases the longer the asset is held before realisation.

Now consider the impact of inflation. We continue to assume that the value of the asset increases at a real pre-tax rate of 10% per annum. In this case, however, we assume that the rate of inflation each year is 5%. The nominal pre-tax rate of increase in the value of the asset is therefore 15.5% per annum. (See Annex 3.2 for an explanation of how this nominal rate is calculated.) Table 3.1 below extracts some of the information from Annex 3.2. The table shows the real value of the first asset after 2, 5, 10, 20 and 30 years, the real tax payable on sale at these times, the real post-tax sale proceeds and the effective rates of tax on the real income realised at these times (with all values rounded to the nearest dollar).

**Table 3.1**  
**Impact of Inflation on Taxable Gains**

Period Asset Held Years	Pre-tax Sale Proceeds \$	Tax Payable \$	Effective Tax Rate %
2	1,210	100	46
5	1,611	273	40
10	2,594	653	31
20	6,727	2,096	20
30	17,449	5,682	14

Note that the effective tax rates are higher than when there is no inflation (when, as noted above, the corresponding effective tax rates were 32, 29, 25, 18 and 13.5%). This increase occurs because the inflationary gain, in addition to the real income, is taxed when there is inflation, but only the real income is taxed in the absence of inflation because, by definition, there is then no inflationary gain.

Note, however, that the difference in the effective tax rates diminishes as the period before realisation increases. Thus, after 2 years, the difference is 14 percentage points; after 5 years, 11; after 10 years, 6; after 20 years, 2; and after 30 years, the two rates are approximately the same. The impact of inflation therefore diminishes the longer the asset is held. This is because the adverse effect of inflation is increasingly offset by the benefit of the accumulation of income free of tax until the year of realisation.

By contrast, under the same assumptions, the effective tax rate on the second type of asset referred to above, where all of the income is taxable each year, would be 49% irrespective of how long it is held.

The results can also be considered in terms of net present values ("NPVs"). The net benefit of the investment to the investor is measured by the NPV of the investment's cash flows after tax. At any given discount rate, the NPV of the investment increases the longer the asset is held. Thus, the tax impost on the gain, relative to the investment's NPV, diminishes over time.

In summary, under the present tax system inflation increases the effective tax rate on income that is taxed on realisation. This effect occurs because both inflationary and real income are taxed. The effect of inflation diminishes as the period before realisation increases since the benefit of the accumulation of income free of tax until realisation increasingly outweighs the impact of inflation.

### 3.5.3 Trading Stock

As outlined in Chapter 2, the taxable profit on the sale of trading stock can be calculated as:

- proceeds from sales of stock
- **plus** the value of closing stock
- **less** the cost of purchases
- **less** the value of opening stock.

In order to simplify the analysis, assume that sale proceeds are measured net of selling costs (other than the cost of the stock) such as wages and salaries. The net effect of the calculation is to subtract from sale proceeds the cost (or, where the alternative valuation rules are adopted, the replacement price or the market value) of the stock sold. If it were practical to identify the cost of each

item of stock sold, profits on the sale of trading stock would be taxed, and affected by inflation, in the same way as profits on the sale of taxable property, as described in section 3.5.2. It is, however, usually not feasible to keep track of the cost of every item of stock. Consequently, various valuation rules are used to value stock on hand on a taxpayer's balance date and hence, by deduction, the value of the stock sold during the year.

On the assumption that taxpayers generally value trading stock at cost, the effect of the other valuation rules are ignored for the purposes of this analysis. Simplifying further, the basic rule is that trading stock is valued at historical cost, with the cost of stock on hand determined on a "first-in, first-out" ("FIFO") basis.

Annex 3.3 analyses the impact of inflation on the taxation of trading stock. Since we are only interested in the impact of inflation, to make the example as simple as possible, it is assumed that all stock is acquired at the end of an income year and that all income from the sale of stock is ploughed back into additional units of stock (except for the final disposal). It can be seen from Table 3.3.1 of the annex that, in the absence of inflation, the effective tax rate on the profits on sale of trading stock is equal to the relevant statutory tax rate, provided that stock turnover (i.e., the ratio of sales to stock) is greater than one. Where stock is held for more than one year, the effective tax rate on profits on sale will fall below the statutory rate (as illustrated in Annex 3.2 in the case of taxable capital gains). Since, however, stock is usually not held as long as this, the results in Table 3.3.1 can be considered to be representative of the treatment of trading stock generally.

Now consider the impact of inflation. This is also illustrated in Table 3.3.1 of Annex 3.3. It can be seen that the effective tax rate on the real profit on sale rises as the inflation rate increases, irrespective of the rate of stock turnover. For example, if the rate of inflation were 5%, the effective tax rate is approximately 46%. Thus, even at moderate rates of inflation, the effective tax rate on the real profit from the sale of trading stock significantly exceeds the statutory tax rate.

If the inflation rate is, say, 10%, the effective tax rate rises to around 58%. Note that this result is not very sensitive to the rate of stock turnover.

### **3.5.4 Depreciable Assets**

As outlined in Chapter 2, New Zealand currently has an historical cost depreciation system. That is, depreciation is calculated as a certain percentage of the depreciated historical cost (i.e., original cost less allowed depreciation) of an asset. Because the depreciated historical cost of an asset is fixed in nominal terms, the corresponding depreciation deductions are also fixed in nominal terms. Hence, the real value of the deductions is eroded as a result of inflation.



The effect of inflation on depreciation is explored in Annex 3.4. In order to isolate the effect of inflation (as distinct from, say, incorrect tax depreciation rates), the annex and the remainder of this document assume that tax depreciation rates are true economic depreciation rates in the absence of inflation, but that they are not adjusted in any way to take inflation into account. Economic depreciation is assumed to be best approximated by diminishing value depreciation. As at present, excess depreciation is assumed to be reassessed on the disposal of an asset.

Under these assumptions (and others set out in Annex 3.4), in the absence of inflation the effective tax rate on the real income generated by a depreciable asset is the same as the statutory tax rate. (Note that, in practice, the effective tax rates on depreciable assets will diverge from the statutory rate because of factors such as the failure of tax depreciation to match economic depreciation rates and lags in the tax payment system.)

When inflation is introduced, the effective tax rate rises. A number of points should be noted. First, as illustrated in Table 3.4.1 of the annex, the increase in effective tax rates is significant even at low rates of inflation. For example, the effective tax rate on an asset with an economic life of 10 years rises from 33% in the absence of inflation, to 38% when the inflation rate is 2% per annum and 45% when the inflation rate is 5%.

Secondly, as can be seen from the table, the effective tax rate rises as the inflation rate rises because the inflationary component of the income, in addition to the real income, is taxed. The greater the inflationary component, the greater the inflationary tax impost. Hence, the effective tax rate rises with the rate of inflation.

Thirdly, note that effective tax rate decreases as the economic life of the asset increases, though the effect is not significant at low rates of inflation. As the rate of inflation increases, the divergence between the effective tax rate on short- and long-lived assets increases. For example, under the assumptions outlined above, the effective tax rate at a 10% inflation rate decreases from 59% for an asset with an economic life of 5 years to 42% for an asset with an economic life of 40 years.

It can be shown that the impact of inflation on the taxation of depreciable assets also depends on the amount of the residual value of a depreciable asset. In particular, the higher the residual value of the asset relative to its initial purchase cost, the lower the effective tax rate. This effect is, however, not very significant. For example, the effective tax rate on an asset with an economic life of 15 years decreases from 44% to 41% as the residual value of the asset in real terms increases from 5% to 50% of its initial value (assuming a 5% rate of inflation).

**3.5.5 Financial Arrangements**

Sections 64B to 64M of the Act deal with income and expenditure relating to financial arrangements. As discussed in Chapter 2, these types of income and expenditure are generally brought to account on an accrual basis, subject to a de minimis rule which permits certain taxpayers to report income and/or expenditure on a cash basis.

As in all of the preceding cases, inflation increases the effective tax rate on the real income derived from a financial arrangement. This is illustrated in Table 3.2 below. The statutory tax rate is assumed to be 33%. For the purposes of the table, it is assumed that the calculated yield to maturity proves to be the true yield.

**Table 3.2  
Effective Tax Rates on Financial Arrangements**

Inflation Rate %	Effective Tax Rate %
0	33.0
1	36.3
2	39.5
5	48.7
7	54.5
10	63.0

As can be seen from the table, the effective tax rate rises significantly as inflation increases. Under the assumption of a uniform inflation rate, the effective tax rates are independent of the term of the arrangement.

**3.5.6 Conclusion: Impact of Inflation**

There are two important results to note:

- first, inflation increases the effective tax rate on real income produced by all forms of capital because both real income and inflationary gains are taxed under the present tax system; and
- secondly, inflation causes the real effective tax rates on different types of assets to diverge. In general, where income is taxed on a realisation basis, the longer the holding period of the asset, the less the impact of inflation. Where, however, income is partially or fully accrued for tax purposes, the real effective tax rate increases as the inflation rate increases.

These are the reasons why the effect of inflation on the present historical tax system is of concern from an efficiency perspective. As demonstrated in this section, inflation has a divergent impact on the effective rate of tax levied on income from different types of assets. To the extent that inflation is anticipated by investors, the result of a tax system that takes no account of inflation is to alter investment and other business decisions in a manner that is likely to be detrimental to overall national welfare.

Considerations of this kind led the 1982 McCaw Task Force to recommend that, "as a matter of urgency, an investigation should be undertaken with a view to introducing a comprehensive system of inflation adjustments for business income tax purposes." The concerns that led to that recommendation are still valid even in today's environment of much lower inflation.

### **3.6 Other Issues**

The general tax exemption for income on capital account and the lack of adjustment in the income tax system for inflation have been identified as the main factors contributing to a divergence between actual income derived by people and income as it is presently measured for tax purposes, and the resulting inequities, inefficiencies and compliance difficulties flowing from that divergence. Those issues are therefore the focus of this Document.

There are nevertheless a number of other factors contributing to this divergence. Those other factors are outlined briefly in this section. This is indicative of potentially desirable future taxation reforms in this area. However, only those issues that interact directly with the two main issues will be considered in detail at this stage.

#### **3.6.1 Timing of Income Recognition**

Throughout the income tax system, timing issues produce significant divergences between a person's actual income and income as measured for tax purposes. These timing differentials can be almost as important as total tax exemptions.

As explained in Chapter 2, a gain in wealth represents income and is earned irrespective of whether that gain is realised in cash or a cash-equivalent. Unless taxable income is measured on a full accrual basis, the result will be a divergence between actual and measured income, with incentives for taxpayers to invest in areas that defer the time at which tax must be paid. This is the case under our existing income tax system which, as a general rule, does not recognise income from a gain on an asset until the income is realised.

As discussed in section 3.5.2 and Annex 3.2, the resulting deferral of taxation liabilities can be significant enough to overwhelm any excess tax imposed by taxing income on a non-inflation-adjusted basis. The result is that the tax system, even where it taxes gains on investments, encourages investments in

assets producing gains the realisation of which can be deferred for a considerable period in comparison with investments in assets producing gains the realisation of which are not deferred. In addition, taxpayers can often deliberately defer a tax liability where income is recognised only on realisation by deferring realisation.

Recent reforms have attempted to bring forward the recognition of income to reflect more closely a full accrual basis. The main example is the accruals regime. Nevertheless, it is recognised that there are practical constraints on the extent to which the timing of income recognition can be aligned with the timing of when income is actually earned. The issue of whether accrual methods are feasible in taxing income derived on the disposal of property is canvassed in Chapter 12.

### **3.6.2 Timing of Expenditure Recognition**

Just as there are significant problems with the timing of income recognition under existing rules, so there are significant problems with the timing of expenditure recognition. As outlined in Chapter 2, expenditure on a lasting asset should be deductible over the economic life of the asset. While this treatment currently applies to depreciable assets (subject to appropriate depreciation rates), it does not apply to expenditure on other assets. Expenditure on other assets is either deductible as incurred or non-deductible.

Where the expenditure is non-deductible (and the asset produces income and is not for private or domestic use), not allowing a deduction for that expenditure as the asset declines in value is a penalty. On the other hand, many forms of expenditure on lasting assets have been treated as being on revenue account and are deductible as incurred (subject to special rules such as section 104A). Examples are wages and salaries incurred in constructing assets and some forms of advertising.

The result is that the current tax system can discourage some forms of expenditure and encourage others and provide concessions to some taxpayers and penalise others. A fair and efficient tax system would remove such distortions. The necessary changes would, for example, involve rules for the capitalisation of some types of expenditure that are currently immediately deductible. Deductibility should then, in principle, be provided on an amortisation basis. Examples of such rules are currently found in the farming and forestry regimes. The accrual rules can have the same effect. Other jurisdictions, such as the United States of America, have more comprehensive capitalisation and amortisation rules.

Nevertheless, there are a number of problems in making such rules work in a practical manner without undue administrative and compliance costs. Such rules also need to be integrated with other provisions of the Income Tax Act.

The most common capitalisation rule in the Act at present is one that denies a deduction for expenditure on purchasing property that gives rise to an assessable gain on realisation, then allows the expenditure to be deducted against proceeds in calculating the taxable profit or gain in the year of disposal. Examples are expenditure on planting forests and investment expenditure by life offices under section 204. Deductibility is denied in such cases until the profit or gain is realised as a partial offset for the lack of tax on income as it accrues. This rule also means that any net loss on the investment is deferred until the loss is realised. Although the position may sometimes be arguable, the same rule is intended to apply to property subject to tax under sections 65(2)(3) and 67.

In some cases, deferring recognition of income until it is realised can cause problems by allowing taxpayers to selectively realise investments that have fallen in value and defer realising those that have risen. In that way, a taxpayer can organise its affairs to earn income but incur no tax liability.

These effects are considered further in Chapter 12.

### **3.6.3 Trading Stock**

A problem closely related to income and expenditure timing issues arises with respect to the current trading stock rules. As outlined in Chapter 2, taxpayers have a discretion when determining the closing value of particular items of trading stock. They can choose to value such stock at cost, market value or replacement cost. This choice gives them the ability to recognise losses where the market value of trading stock has declined (by valuing at market value) while deferring income by valuing trading stock that has not declined in value at cost. As a result, taxpayers in some circumstances, especially where the value of trading stock (e.g. shares) is highly variable, can reduce taxable income by bringing forward losses and deferring gains.

The ability to vary the basis for valuing closing trading stock can also allow taxpayers to bring forward income and create a future loss where that might be desirable because of the sale of a company in tax loss or because of an anticipated increase in tax rates. For example, by rewriting trading stock up from a cost to a higher market basis prior to sale, past tax losses can be utilised. After the sale, the purchaser can then write the trading stock back down to cost achieving a tax deduction in the process.

The possibility of altering the rules on the valuation of trading stock to alleviate these problems is considered in Chapter 16.

### **3.6.4 Losses, Sections 129 and 188A, and Section 99**

As outlined in Chapter 2, current law attempts to restrict the ability of shareholders in companies to utilise losses incurred by companies in which they have an interest and the ability of companies to carry losses forward from

one year to the next. There is an economic case for suggesting that losses should be able to be more easily utilised. If the ability to utilise a tax loss is denied, there is a disincentive to invest in risky assets or ventures. Where such an asset or venture produces high returns, those returns are taxed. If, however, the activity or venture produces a loss, that loss may not be able to be used to offset the tax on other income because of the above restrictions.

The restrictions against the carrying forward of losses can therefore operate to defeat the object of tax neutrality. Nevertheless, New Zealand is not alone in treating losses in this restrictive manner. Other countries with comparable tax systems also have limitations on the ability to utilise losses. The main reason is that the divergence between taxable income and actual income is often such that the authorities cannot be confident that losses are actual losses. In other words, too much of a relaxation of the loss limitation rules could lead to too great an opportunity for taxpayers to structure their affairs to escape tax on what would otherwise be assessable income.

Given the inherent difficulties of fully aligning taxable income with actual income, such considerations are likely to remain important. Nevertheless, if attempts to more closely align taxable and actual income in New Zealand are successful, the restrictions on the ability of companies to utilise losses from one income year to another could possibly be relaxed to some extent.

For the same reasons, the measures put forward in this Document for widening the income tax base should eliminate the need to retain sections 129 (interest clawback) and 188A (\$10,000 loss limitation). As outlined in Chapter 2, these provisions are often avoided in practice and they now have limited application.

Successful implementation of the reforms proposed in this document and other reforms more closely aligning taxable and actual income could also allow consideration to be given to reviewing section 99 of the Act (the general anti-avoidance provision) with a view to tuning it more finely to identifiable tax abuses. As noted in section 3.3.2, it is often difficult to know the precise scope of the section because what is and what is not "tax avoidance" can be a matter of debate. Some general anti-avoidance provision will probably always be required, but a more robust income tax system would provide an opportunity to consider a provision that taxpayers and the Inland Revenue Department could work under with more certainty.

### **3.7 Conclusion**

Chapter 2 of this Document outlined the main features of the current income tax regime applying to income from capital and related areas. It was evident in that chapter that there are a number of problems with those rules. These problem areas were considered in more depth in this chapter.

Taxation reforms over the past five years have considerably improved the fairness and efficiency of the income tax system. However, there is room for improvement.

In particular, two central problems remain:

- the arbitrary and vague boundary between forms of income that are assessable and those that are exempt on the basis that they are income on capital account; and
- the lack of any adjustment for inflation in the way that taxable income is measured.

The exemption for certain forms of income on capital account is a product of history. It makes the tax system unfair and increases its costs. It encourages investment in forms that do not maximise growth and jobs. It allows taxpayers who have access to costly expert advice to escape tax. It benefits the wealthy and it creates uncertainty as to the tax consequences of investments.

The lack of inflation-adjustment in the measurement of taxable income also increases the costs of the tax system and its perceived fairness. Income which is merely the product of inflation is taxed. Different types of assets are taxed differently, thus encouraging investment in one form of asset over another.

The tax system would be substantially improved if these remaining two major problems could be rectified. The ability to do so rests on the feasibility of reforms that address the problems without imposing undue administrative and compliance costs on taxpayers and the revenue authorities. The remainder of this Document outlines a regime which should be able to meet this criterion.

## **ANNEX 3.1**

### **Distributional Effects of Reforming the Taxation of Capital Income**

#### **Introduction**

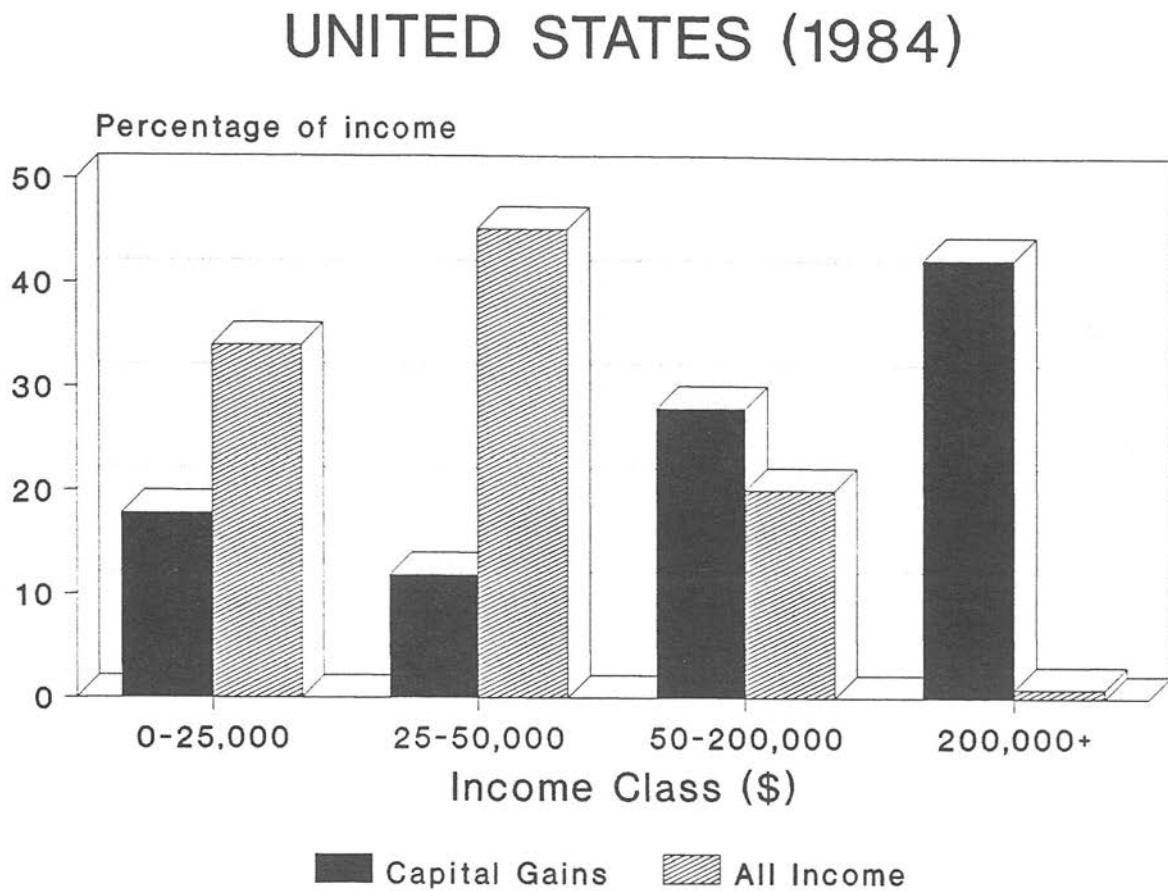
The purpose of this annex is to summarise the likely distributional effects of removing the present exemption for income on capital account. Since there are no data available on such income in New Zealand, it is necessary to draw inferences from overseas data as the basis of assessing the likely distributional impact in New Zealand. The income most similar to the income that would become taxable under the reforms outlined in this document is income referred to in other countries as "capital gains". This annex therefore presents data from the United States, Australia and Canada on the distribution of capital gains.

#### **Overseas Data on Distribution of Realised Capital Gains**

Overseas data indicate that taxed capital gains are highly concentrated among the top income group and are distributed much less uniformly than other sources of income. The distribution of capital gains income as compared to all income by income class in the United States, Australia and Canada is shown in Figures 3.1.1-3.1.3 and Tables 3.1.1-3.1.3.



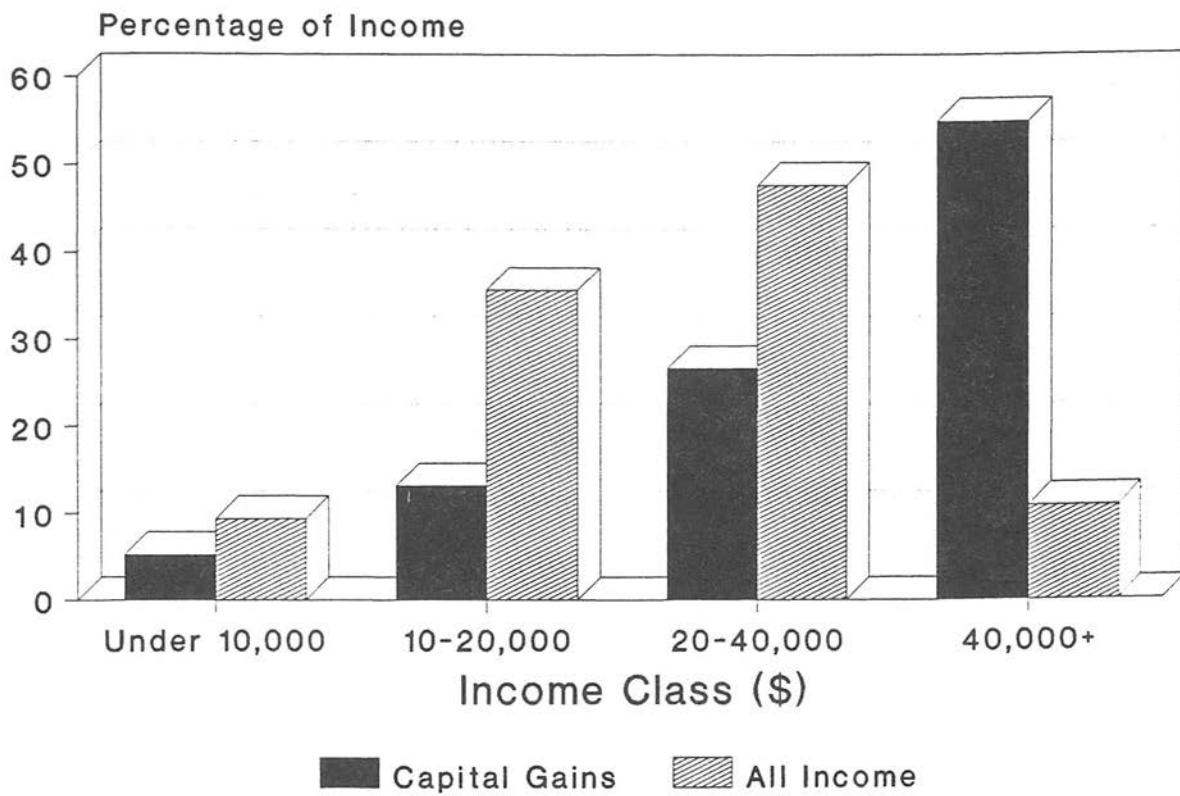
**FIGURE 3.1.1**  
**Distribution of Capital Gains**  
**and all Income by Income Class**



As this figure shows, in the United States in 1984, returns with income in excess of US\$200,000 (the top 0.24 % of returns) received 42.36 % of capital gains, compared to 0.83 % of all income.

**FIGURE 3.1.2**  
**Distribution of Capital Gains**  
**and All Income by Income Class**

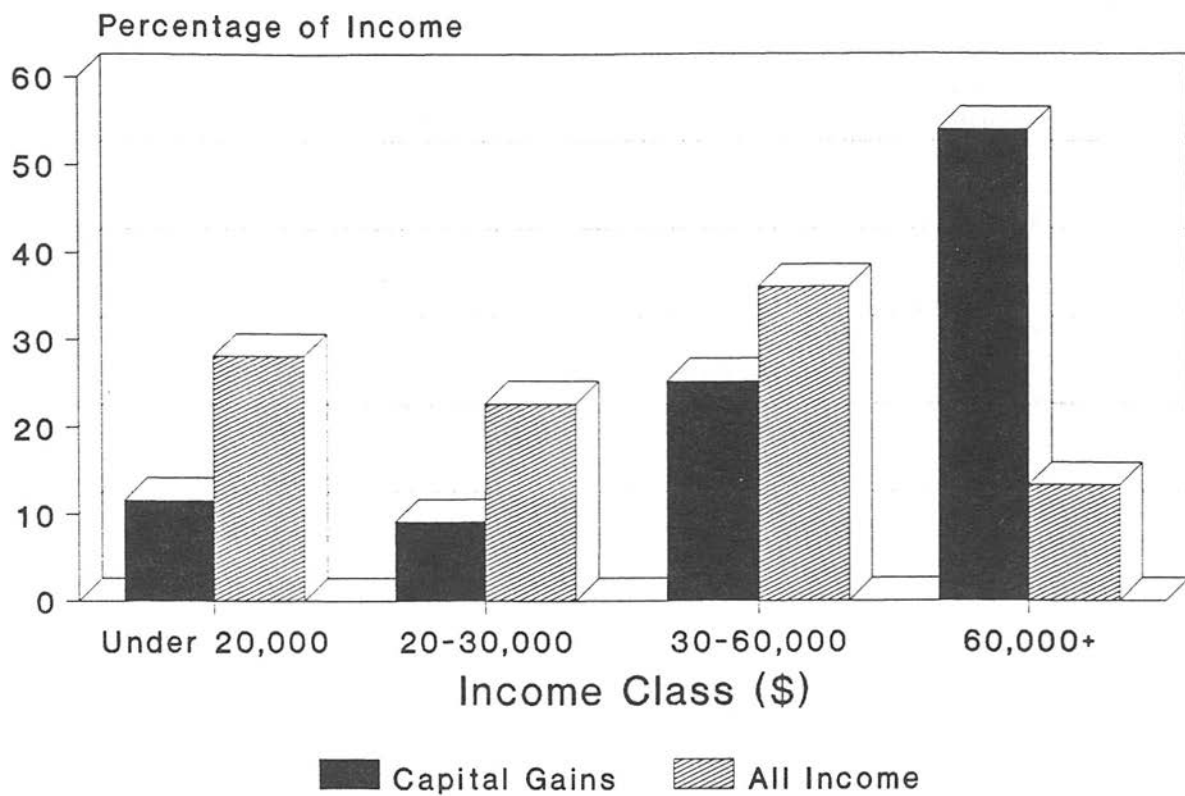
## AUSTRALIA (1985)



In Australia in 1985, returns with income over \$A100,000 (the top 3.36% of returns) received 55% of (inflation-adjusted) gains, compared to 10.85% of all income.

**FIGURE 3.1.3**  
**Distribution of Capital Gains**  
**and All Income by Income Class**

## CANADA (1985)



As this figure indicates, in Canada in 1985, returns with income in excess of C\$60,000 (the top 2.4% of returns) received 54% of capital gains, compared to 13.3% of all income.

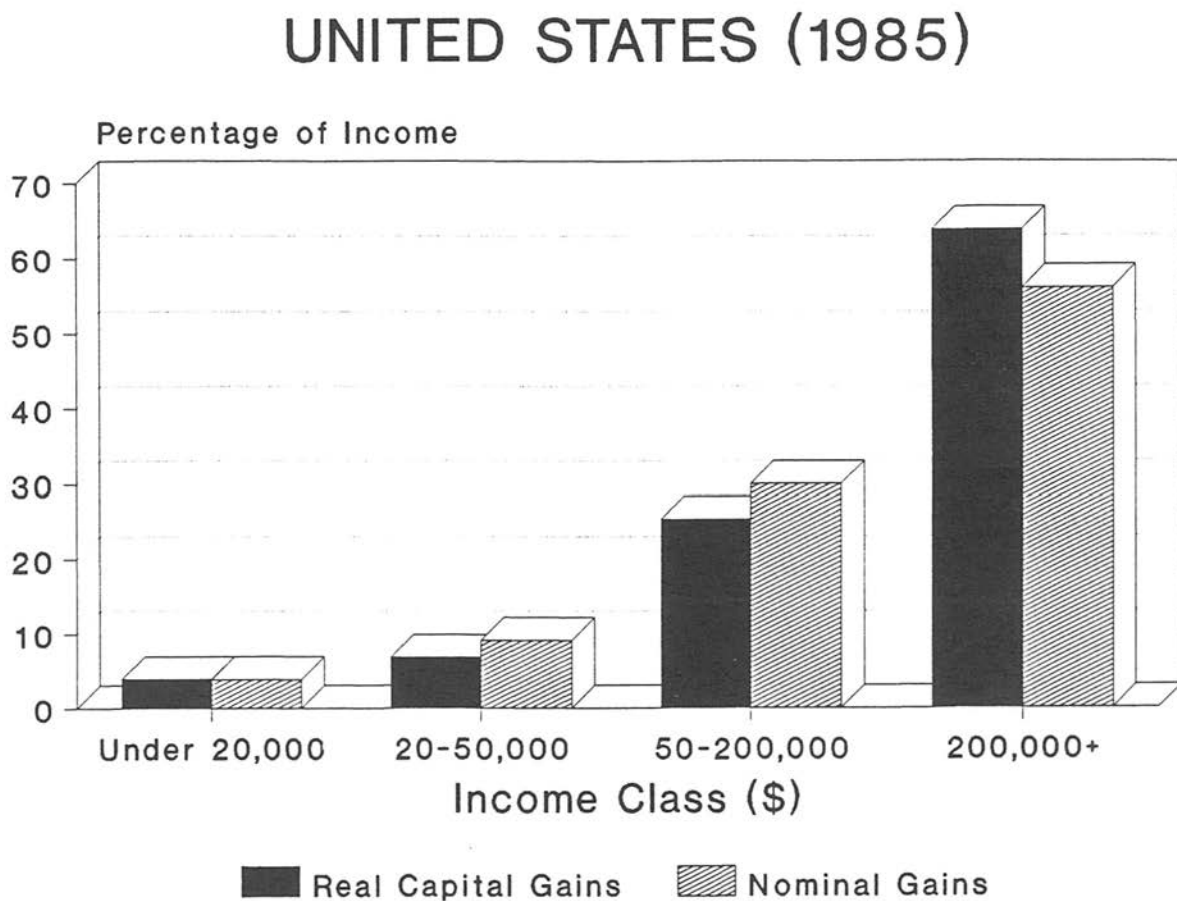
These figures overstate to some extent the degree of concentration of gains among the top income groups because they are based on data for a single tax year. To the extent that some individuals realise large amounts of gains in some years but not in others, data from any one year reflect in part the temporary movement of people in and out of high income groups and overstate the permanent concentration of capital gains among those with high permanent income levels. Data from other studies that follow taxpayers over time confirm, however, that capital gains are highly concentrated among those with high permanent incomes, although the degree of concentration is somewhat less than observed from single year data.

The concentration of capital gains among the top income groups would also be somewhat less extreme if personal residences were included in the tax base because home ownership is more widely dispersed among the population than ownership of other assets that produce significant amounts of capital gains, such as corporate equity, commercial property, and interests in partnerships and small business enterprises.

### **Effect of Inflation on Distribution of Realised Capital Gains**

Studies in the United States have shown that if the capital gain provisions were adjusted for inflation, such gains would be more highly concentrated in the top income bracket than gains that are not inflation-adjusted. This is shown in Figure 3.1.4.

**FIGURE 3.1.4**  
**Comparison of Distribution of Real and**  
**Nominal Capital Gains by Income Classes**



In the United States, the top income class (those with income US\$200,000 or above) received 56.1% of nominal gains, but it is estimated they received 63.9% of real gains.

**TABLE 3.1.1**  
**Distribution of Capital Gains Income, Wages and Salaries,**  
**Dividend Income and all Income by Income Class**

**UNITED STATES (1984)**

Income Class (US\$000 1984){1}	Percentage of Taxpayers Each Class{2} (%)	Capital Gains (%)	Wages and Salaries (%)	Dividends (%)	All Income (%)
1,000+	0.01	21.44	0.30	7.65	0.31
500-1,000	0.03	8.12	0.36	3.98	0.36
200-500	0.20	12.80	1.59	9.69	0.16
100-200	0.77	11.99	3.35	12.91	3.40
750-100	1.06	6.30	3.47	8.70	3.52
50-75	4.68	9.63	12.94	14.28	13.13
40-50	6.00	4.97	13.51	8.10	13.70
30-40	11.14	4.87	20.16	8.43	20.45
25-30	7.68	2.00	10.87	3.61	11.03
20-25	8.87	2.69	10.00	5.44	10.14
15-20	11.55	3.15	9.89	5.67	10.03
10-15	14.14	2.54	8.46	5.21	8.58
5-10	16.54	1.64	5.80	3.72	5.89
1-5	16.33	0.94	1.96	1.34	2.00
Nil	1.01	6.91	-2.65	1.26	-2.69

**Source**

Calculated from data in US Internal Revenue Service, Statistics of Income - Individual Income Tax Returns, 1984.

**Notes**

- {1} The income classes are arrived at using different methods for each country. The United States uses the Adjusted Gross Income of the taxpayer and Australia uses gross taxable income. This may reduce the comparability of the statistics.
- {2} This column shows the number of taxpayers in each class as a percentage of the total number of taxpayers.

**TABLE 3.1.2****AUSTRALIA (1985)**

Income Class (A\$000 1985){1}	Percentage of Taxpayers Each Class{2} (%)	Capital Gains (%)	Wages and Salaries (%)	Dividends (%)	All Income (%)
100+	0.17	27.26	0.75	11.94	1.56
50-100	1.24	18.46	3.61	17.33	4.44
40-50	1.95	9.23	4.82	9.34	4.85
35-40	2.66	6.34	5.65	7.45	5.56
30-35	4.95	5.49	9.58	8.24	9.01
20-30	24.30	14.81	30.59	18.23	33.09
15-20	22.08	6.24	23.30	9.67	21.70
10-15	19.65	6.93	13.53	8.93	13.91
5-10	22.54	5.05	8.17	7.36	9.02
Under 5	0.43	0.20	0.02	0.42	0.35

**Source**

Taxation Statistics 1985-86, Australian Taxation Office, Australian Government Publishing Service, Canberra 1988.

**Notes**

- {1} The income classes are arrived at using different methods for each country. The United States uses the Adjusted Gross Income of the taxpayer and Australia uses gross taxable income. This may reduce the comparability of the statistics.
- {2} This column shows the number of taxpayers in each class as a percentage of the total number of taxpayers.

**TABLE 3.1.3****CANADA**

Income Class (C\$000 1985){1}	Percentage of Taxpayers Each Class{2} (%)	Capital Gains (%)	Wages and Salaries (%)	Dividends (%)	All Income (%)
1,000+	0.66	37.64	3.63	42.46	6.55
80-1,000	0.46	6.80	1.47	8.08	2.11
60-80	1.32	9.51	4.09	13.55	4.63
50-60	1.91	7.57	5.59	8.12	5.34
45-50	1.92	3.78	5.28	4.45	4.68
40-45	3.11	4.46	7.91	4.39	6.78
35-40	4.45	4.53	10.05	4.31	8.57
30-35	6.30	4.85	12.25	3.91	10.52
27-30	4.66	2.66	7.83	2.64	6.84
25-27	3.36	1.88	5.04	0.88	4.51
22.5-25	4.53	2.30	6.06	2.08	7.78
20-22.5	5.32	2.27	6.21	0.84	3.50
10-20	26.40	7.71	18.42	3.49	20.08
Under 10	30.87	3.18	6.17	0.76	8.16
Loss or Nil	4.73	0.67	0.03	0.04	-0.14

**Source**

Taxation Statistics 1985.

**Notes**

- {1} The income classes are arrived at using different methods for each country. The United States uses the Adjusted Gross Income of the taxpayer and Australia uses gross taxable income. This may reduce the comparability of the statistics.
- {2} This column shows the number of taxpayers in each class as a percentage of the total number of taxpayers.



**TABLE 3.1.4**  
**Distribution of Nominal Capital Gains**

**UNITED STATES (ALL TAXPAYERS) 1984**

Expanded Income Class US\$000	Net Long-Term Gains				
	Returns	%	Amount (\$M)	%	Average (\$)
less than zero	53,392	1.28	1,213	1.09	22,717
zero - 10	415,562	9.96	802	1.25	1,930
10 - 20	324,901	12.57	994	1.55	1,894
20 - 30	611,987	14.66	2,302	3.50	3,762
30 - 40	512,959	12.29	1,808	2.81	3,524
40 - 50	429,062	10.28	1,828	2.84	4,261
50 - 75	769,193	10.43	5,469	8.51	7,109
75 - 100	329,251	7.89	4,954	7.71	15,047
100 - 200	355,283	8.51	8,844	13.76	26,892
200 - over	172,643	4.14	36,063	56.11	208,890
Total all Returns	4,174,233	100.00	64,277	100.00	15,399

**TABLE 3.1.5**  
**Distributional Effect of Real Capital Gains**

**UNITED STATES (ALL TAXPAYERS) 1985**

Expanded Income Class US\$000	Net Long-Term Gains				
	Returns	%	Amount (\$M)	%	Average (\$)
less than zero	33,329	1.08	911	1.91	27,327
zero - 10	309,697	10.06	437	0.92	1,411
10 - 20	341,165	11.08	518	1.09	1,510
20 - 30	403,166	13.09	1,395	2.93	3,461
30 - 40	409,413	13.29	1,060	2.23	2,589
40 - 50	268,122	8.70	813	1.71	3,031
50 - 75	601,206	19.52	3,177	6.68	5,284
75 - 100	266,378	8.65	3,017	6.34	11,325
100 - 200	294,559	9.56	5,847	12.29	19,851
200 and over	153,327	4.98	30,406	63.90	198,306
<b>Total all Returns</b>	<b>3,080,362</b>	<b>100.00</b>	<b>47,580</b>	<b>100.00</b>	<b>15,446</b>

## ANNEX 3.2

### Impact of Inflation on the Taxation of Income Derived from the Sale of Assets

#### Introduction

The purpose of this annex is to illustrate in more detail the impact of inflation on the taxation of assessable income derived on the disposal of property. This issue can be usefully analysed in terms of effective tax rates. As outlined in Chapter 1, the effective tax rate on an income stream is the rate  $e$ , say, such that:

$$e = 1 - r/R$$

where

$$\begin{aligned} r &= \text{the post-tax rate of return and} \\ R &= \text{the pre-tax rate of return.} \end{aligned}$$

#### Assumptions

For the purposes of this annex, it is assumed that:

- the real value of the asset increases at a rate of 10% per annum;
- the profit derived on the disposal of the asset, calculated as the difference between its cost and its sale value, is taxable in the year in which the asset is sold;
- the rate of inflation is constant each year;
- the statutory tax rate is 33%; and
- differences in the timing of the receipt of sale proceeds and tax payment dates in the year of disposal can be ignored.

#### Results

Before examining the impact of inflation, it is useful to consider the way in which effective tax rates on realised income vary with the period before realisation in the absence of inflation. This is illustrated in Table 3.2.1.

**TABLE 3.2.1**  
**Effective Tax Rates on Realised Income: No Inflation**

Holding Period (years)	Effective Tax Rate (%)
1	33.0
5	29.0
10	24.6
15	21.0
20	18.0
25	15.5
30	13.6
35	12.0
40	10.7
45	9.6
50	8.7

As can be seen from the table, the (real) effective tax rate on income taxed on realisation decreases the longer the period before realisation. As explained in section 3.5.2, this reduction occurs because the longer the period before realisation, the greater the amount that accumulates at the pre-tax rate of return relative to the tax that is ultimately payable. That is, because all of the tax on the income is payable only in the year of sale, the income accumulates at the pre-tax rate of return. The effect of compound growth at this rate more than offsets the effect of the increase in the amount of the tax liability in the year of sale.

Now consider the impact of inflation at a uniform annual rate of 5%. The effective tax rate on the real income derived in this case is shown in Table 3.2.2.

**TABLE 3.2.2**  
**Effective Tax Rates on Realised Income: 5% Inflation**

Holding Period		Effective Tax Rate	Increase Relative to No Inflation Case
Years		%	% points
1		48.7	15.7
5		40.1	11.1
10		31.4	6.8
15		25.0	4.0
20		20.3	1.7
25		16.9	1.4
30		14.3	0.7
35		12.4	0.4
40		10.9	0.2
45		9.7	0.1
50		8.8	0.1

As the table indicates, inflation increases the effective tax rate on real income. Not only is the real income taxed, but also the inflationary income. The shorter the holding period, the greater the impact. As the holding period increases, the adverse impact of taxation on the inflationary component is increasingly offset by the beneficial impact of income accumulation at an (untaxed) pre-tax rate.

As might be expected, the adverse impact of inflation is exacerbated as the inflation rate increases. This is illustrated by Table 3.2.3, which reproduces the previous table assuming a 10% inflation rate.

**TABLE 3.2.3**  
**Effective Tax Rates on Realised Income: 10% Inflation**

Holding Period	Effective Tax Rate	Increase Relative to No Inflation Case
Years	%	% points
1	63.0	30.0
5	48.7	19.7
10	35.7	11.1
15	27.0	6.0
20	21.2	3.2
25	17.3	1.8
30	14.5	1.0
35	12.5	0.5
40	10.9	0.2
45	9.7	0.1
50	8.8	0.1

As can be seen from the table, an increase in the inflation rate sharply increases the effective tax rates on income at shorter holding periods, but the effect diminishes as the holding period lengthens. For holding periods in excess of, say, 30 years, inflation has only a minor impact on effective tax rates.

## ANNEX 3.3

### Impact of Inflation on the Taxation of Trading Stock

#### Introduction

This annex considers the impact of inflation on the effective tax rates applying to profits on the sale of trading stock.

#### Comment

For simplicity, suppose that \$1,000 of stock is acquired at the end of year 0 and sold at the end of year 1. Also assume that the stock guarantees a real pre-tax rate of return of 10 percent. In the absence of inflation, assessable income in year 0 would be zero. The deduction for the cost of trading stock would be balanced by the increase in the value of closing stock. In year 1, the taxpayer would earn revenue of \$1,100 but could claim a deduction for the fall in closing stock of \$1,000. Assessable income would be \$100 and tax would be \$33. The stock would generate a real post-tax rate of return of 6.7 percent and effective tax rate of 33 percent.

If the stock turned over a greater number of times per year, the analysis would be unaffected. For example, suppose that the stock turned over six monthly and that the income from the sale of stock is reinvested by the firm. Once again assuming that the stock generates a 10 percent pre-tax rate of return, this implies that the stock sold midway through year 1 is sold for \$104. This amount is reinvested in trading stock which is sold for \$1,100 at the end of the year. Once again assessable income in year 0 is zero and in year 1 is \$100. The real post-tax rate of return is 6.7 percent and effective tax rate is 33 percent. In effect provided stock is turned over at least once a year, the tax treatment of the income is the same as that of interest.

Now suppose the inflation rate is 5 percent per annum, and stock turns over once per annum and generates a 10 percent real pre-tax rate of return. Once again at the end of year 0 \$1,000 of stock is acquired and assessable income is zero. At the end of year 1, the stock is sold for \$1,155 and in the absence of indexation assessable income is \$155. Tax is \$51.15. The real post-tax rate of return is 5.1 percent and effective tax rate is 49 percent.

The taxpayer is taxed fully on both the real and the inflationary component of income. At assumed inflation rates of 0, 2, 5, 7 and 10 percent effective tax rate would be 33.0, 39.5, 48.7, 59.6 and 63.0 percent respectively. Effective tax rates increase with the rate of inflation.

## **ANNEX 3.4**

### **Impact of Inflation on the Taxation of Depreciable Assets**

#### **Introduction**

This annex explores in more detail the impact of inflation on the effective tax rates on depreciable assets.

#### **Assumptions**

For this purpose, it is assumed that:

- the asset generates a real pre-tax rate of return of 10% per annum;
- tax depreciation rates are equal to true economic depreciation rates in the absence of inflation. Economic depreciation is defined as the decline in the market value of the asset. Thus, real economic depreciation is defined as the decline in the real value of the asset, while nominal economic depreciation is defined as the decline in the nominal market value of the asset. Since we are interested here in the effect of inflation, we assume that tax depreciation rates are equal to economic depreciation rates in the absence of inflation, but are not adjusted for inflation;
- the market value of the asset declines at a uniform exponential rate;
- the excess, if any, of the disposal value of the asset at the end of its economic life or its original cost, whichever is less, over its depreciated book value is assessed in the year of sale. This is the current rule applying in New Zealand;
- the statutory tax rate is 33%; and
- the inflation rate is constant each year.

None of these assumptions is critical. All of them could be relaxed without altering the qualitative results shown in this annex.

#### **Results**

Table 3.4.1 illustrates the impact of inflation on real effective tax rates on depreciable assets with different economic lives, given the assumptions outlined.



**TABLE 3.4.1**  
**Real Effective Tax Rates on Depreciable Assets**

Economic Life (years)	Inflation Rate %				
	0	2	5	7	10
5	33	39	47	52	59
10	33	38	45	49	54
15	33	38	43	47	51
20	33	37	42	45	48
25	33	37	41	43	46
30	33	36	40	42	44
35	33	36	40	41	43
40	33	36	39	40	42

As can be seen from the table, the effective tax rate, given the above assumptions, is equal to the statutory rate in the absence of inflation. As the inflation rate rises, so do effective tax rates. Note that the increase in effective tax rates is significant even at low rates of inflation. More importantly, while effective tax rates are uniform in the absence of inflation, this uniformity is lost once there is inflation. The disparity in rates increases as the inflation rate increases. The longer the economic life of a depreciable asset, the lower the effective tax rate for any given rate of inflation.

These factors are the reason why the impact of inflation on the tax system is important from an economic efficiency perspective. Inflation changes the relative rates of return on depreciable assets, thereby affecting investment choices.

Table 3.4.2 illustrates the impact of varying the residual value of the asset. In this case, the real residual value of the asset at the assumed end of its economic life is assumed to be 20% of its initial value rather than 10% as in Table 3.4.1.

**TABLE 3.4.2**  
**Real Effective Tax Rates on Depreciable Assets**

Economic Life (years)	Inflation Rate %				
	0	2	5	7	10
5	33	39	47	52	58
10	33	38	44	48	53
15	33	37	43	46	49
20	33	37	41	44	46
25	33	36	40	42	44
30	33	36	39	41	42
35	33	36	38	40	41
40	33	35	38	39	40

A comparison of the effective tax rates in Tables 3.4.1 and 3.4.2 shows that the rates in Table 3.4.2 are slightly lower. This follows from the fact that the rates of depreciation assumed are slightly lower than in Table 3.4.1 because the residual value is higher.

## **PART II: REAL INCOME TAX**



# CHAPTER 4: INDEXATION OF INCOME FROM CAPITAL

## 4.1 Introduction

Part I of this Document surveyed the main features of New Zealand's present tax treatment of income from capital and some of the problems with it. One of the most important problems is the absence of a mechanism to deal with the effects of inflation. As illustrated in Chapter 3, even moderate rates of inflation can result in a substantial over-taxation of real income. The effect of inflation is not uniform - some types of investments are affected more than others. These effects persist long after inflation itself has been brought under control. Thus, to the extent that taxpayers anticipate inflation, their patterns of saving and investment are affected in ways which are not beneficial to the welfare of New Zealand.

The objectives of Part II of this Document are to examine the nature of the existing income tax base; to consider the mechanics and feasibility of comprehensively indexing the base for the effects of inflation; and to assess the desirability of partial or comprehensive indexation.

This chapter briefly outlines the nature of the existing historical cost income tax base and the way in which it differs from both a nominal and a real tax base. The discussion then focuses on the selection of an appropriate target for tax base reform, the role that could be played by inflation indexation and the selection of an appropriate index of inflation.

The feasibility of comprehensively indexing capital income and expenditure for the effects of inflation is examined in the other chapters in this Part. Chapters 5 to 8 consider the mechanics of indexing assets which produce taxable profits on disposal, trading stock, depreciable assets and financial arrangements on the assumption that other forms of capital income can be indexed. Chapter 9 then concludes the discussion of the feasibility of comprehensive indexation by analysing its implications for tax avoidance and government revenue. The directions for future indexation reform are discussed in Chapter 10.

## 4.2 The Nature of the Current Tax Base

### 4.2.1 Real, Nominal and Historical Cost Tax Bases

The present capital income tax base is often considered to be a nominal base. However, as outlined in Chapter 2, it can be best described as an "historical cost" tax base since profits and losses are measured relative to the historical costs of assets and depreciation deductions are based on the historical costs of depreciable assets.

This can be compared with a real or nominal income tax base. Under a real economic income tax base, the real income generated by an asset (including any change in its real market value) would be taxed as it accrues. This would mean that the effective tax rate on the real income generated by any asset would be the same as the statutory tax rate (ignoring differences between the timing of the cash flows generated by the asset and the timing of tax payments). Such a tax system would be neutral across different assets because the effective tax rate on all assets would be the same.

Under a nominal income tax base, all of the nominal income produced by an asset (including the change in its nominal market value) would be taxed as it accrues. In this case, the effective tax rate on the nominal income produced by an asset would also equal the statutory tax rate (once again, ignoring timing effects). It is important to note, however, that under a nominal income tax system, the effective tax on the real income produced by an asset will exceed that levied under a real income tax. Under a nominal income tax base, income from all assets would be taxed on a basis consistent with that currently applying to interest. During periods of inflation, there would be a tax on real wealth as well as a tax on real income.

For example, suppose that an asset generates a real pre-tax rate of return of 10% per annum. If the inflation rate is constant at, say, 5% per annum, the nominal rate of return on the asset would be 15.5% (i.e.,  $((1.1 \times 1.05) - 1) \times 100$ ). This is calculated from the relationship between a nominal rate (i), a real rate (r) and the rate of inflation (p):

$$(1+i) = (1+r) \times (1+p)$$

implying that

$$r = [(1+i)/(1+p)] - 1.$$

Under a real income tax with a statutory tax rate of, say, 30%, the post-tax real rate of return derived would be 7% (i.e.,  $10\% \times (1 - 0.3)$ ). The effective tax rate would be the same as the statutory rate, i.e. 30%. By contrast, under a nominal income tax system, all of the nominal yield of 15.5% would be taxable. At a tax rate of 30%, the post-tax nominal rate of return would be 10.85% (i.e.,  $15.5 \times (1 - 0.3)$ ). The post-tax real rate of return would, however, be 5.57%.

That is:

$$\begin{aligned} r &= [1.1085/1.05] - 1 \\ &= 0.0557 \\ &= 5.57\%. \end{aligned}$$

Since this is lower than the real post-tax rate of return that would be derived under a real income tax (namely, 7%), it is evident that with inflation the

effective tax rate on real income under a nominal income tax system exceeds that under a real income tax. As discussed in Chapter 3, this is because a nominal income tax taxes not only the real income generated by an asset but also the inflationary component of the income.

To illustrate this relationship between the two tax bases, assume that the asset in the above example is a bank deposit with a nominal interest rate of 15.5% payable annually in arrears. Assume that \$1,000 is invested at the end of year 0. Since the investment has a real pre-tax rate of return of 10%, it would generate real income of \$100 at the end of year 1 in year 0 dollar terms. Given that inflation is 5 percent per annum, this is \$105 in year 1 dollar terms. Under a real income tax, assuming a tax rate of 30%, the tax payable would therefore be \$31.50 in year 1 dollar terms.

The nominal pre-tax income produced by the asset would, however, be \$155, given the assumption of a 15.5% nominal pre-tax rate of return. In this case, the tax payable would be \$46.50. The additional tax payable is therefore \$15 in year 1 dollar terms (i.e. the amount invested multiplied by the inflation rate multiplied by the tax rate). This is the "inflationary wealth tax".

The present income base is neither a real nor a nominal income tax. As noted above, under a real economic income tax, the effective tax rate on the real income produced by an asset would be the statutory tax rate. Similarly, the effective tax rate on nominal income under a nominal economic income tax would be the statutory tax rate. In contrast with the existing tax base, a real or nominal income tax base would not distort the relative rates of return from different assets.

The effective tax rates on real income for various classes of assets under the present historical cost income tax were illustrated in Chapter 3. Except in the case of realised profits on assets held for long periods, the effective tax rates on real income under the present tax system exceed the statutory rate whenever there is a positive rate of inflation. Thus, the present tax system generally taxes real income at more than the statutory tax rate when there is inflation. Conversely, the present tax system generally taxes nominal income at less than the statutory rate.

The difference between the existing tax base and a nominal base can be illustrated by examining the effective tax rates that are imposed on the **nominal** income produced by the various types of assets that were considered in Chapter 3. This analysis differs from that in the annexes to Chapter 3 in that those annexes consider the effective tax rates imposed on **real** income.

#### 4.2.2 Effective Tax Rates on Nominal Income

##### **Assets Which Produce Taxable Profits on Disposal**

The first class of assets considered in Chapter 3 consisted of assets (such as

those that produce income that is assessable under section 65(2)(e)) which produce taxable income on sale. Table 4.1 modifies Tables 3.1.1 and 3.1.2 to show the effective tax rates on the nominal income produced in such cases, assuming that the statutory tax rate is 33%.

**Table 4.1**  
**Effective Tax Rates on Nominal Income:**  
**Assets Producing Taxable Profits on Disposal**

Holding Period (years)	Inflation Rate (%)		
	0	5	10
5	29	27	26
10	25	21	19
15	21	17	14
20	18	19	11
25	16	11	9
30	14	10	8

As noted in Chapter 3, the effective tax rates on profits realised on the disposal of assets fall below the statutory rate, even in the absence of inflation, because of the deferral of the tax until the profit is realised. With inflation, the effective tax rates decline further because tax is deferred on a greater amount of income (i.e., on both real and inflationary income). The higher the rate of inflation, the lower the effective tax rates on nominal income.

### **Trading Stock**

It was noted in Chapter 3 that the effective tax rate on real income derived from trading stock is independent of the ratio of sales to stock for trading stock which turn over more than once a year. This is also the case with respect to the effective tax rates on nominal income derived from the sale of trading stock. Since most trading stock is sold within, say, 1-2 years of purchase, there is little if any deferral of the taxation of the full increase in the nominal value of the stock. Hence, the effective tax rates on nominal income derived from the sale of trading stock will generally be close to the statutory rate. For most purposes, it can be assumed that the effective tax rate on nominal income derived from the sale of trading stock is the statutory rate.



## Depreciable Assets

Table 4.2 illustrates the effective tax rates on nominal income produced by depreciable assets. As in Chapter 3, it is assumed that depreciation rates are true economic depreciation rates in the absence of inflation. The example assumes that the residual real value of the asset is 10% of its initial value. Once again, the statutory tax rate is assumed to be 33%.

**Table 4.2**  
**Effective Tax Rates on Nominal Income:**  
**Depreciable Assets**

Economic Life (years)	Inflation Rate (%)		
	0	5	10
5	33	32	31
10	33	31	29
15	33	30	27
20	33	29	25
25	33	28	24
30	33	27	23

As can be seen from the table, the effective tax rates fall below the statutory rate. Thus, the present tax system does not fully tax the nominal income produced by depreciable assets. The nominal income which is not taxed is the increase in the market value of the asset above its depreciated book value each year as a result of inflation. If this were fully taxed on an accrual basis, the effective tax rates on the nominal income produced by depreciable assets would be the same as the statutory rate.

It is important to note that the effective tax rates on depreciable assets may depart markedly from the rates above to the extent that true economic depreciation rates differ from tax depreciation rates.

## Financial Arrangements

Since the nominal income derived from financial arrangements is generally taxed on an accrual basis (subject to a de minimis exception), the effective tax rate on such income is very close to the statutory rate.

### 4.2.3 Conclusion

It can be seen from the above illustrations that the effective tax rates on nominal income derived from taxed assets that yield profits on disposal and depreciable assets under the present income tax system are generally less than the statutory tax rate. The rates on trading stock and financial arrangements are virtually the same as the statutory rate. In addition, the effective tax rates on nominal income are not uniform across different asset types.

Overall, the above results when combined with those in Chapter 3 indicate that the present capital income tax base is somewhere between a real and a nominal economic income tax. Except for realised taxable profits, effective **real** tax rates on most types of capital income exceed the statutory rate, indicating that real income is over-taxed. Conversely, the above analysis suggests that effective **nominal** tax rates on most assets are less than the statutory tax rate. In short, the present capital income tax base generally taxes real income at rates higher than the statutory tax rate but taxes nominal income at rates lower than the statutory rate.

## 4.3 The Appropriate Goal for Tax Base Reform

As noted in section 4.2.1, implementation of either a comprehensive real or nominal economic income tax base would ensure that the tax system was neutral with respect to investment in different assets during periods of inflation. This raises the issue of which of these two alternative tax bases is the more appropriate goal for income tax reform.

In principle, the major advantage of a real income tax base over a nominal base is that it does not result in the over-taxation of real capital income during periods of inflation. Although the implementation of a pure nominal tax base would ensure that the tax system does not bias patterns of investment during periods of inflation, in comparison with a real income tax base a nominal income base would impose much higher marginal rates of tax on real economic income and investment. During periods of inflation a nominal income tax base would in effect impose a tax on real wealth at a rate equal to the rate of inflation multiplied by the taxpayer's marginal tax rate.

A real income tax base is also likely to be preferable to a nominal income base in practice. Contrary to popular belief, major modifications and adjustments for inflation would be required to move the existing tax base onto either a nominal or real economic income base. In order to move the existing tax base onto a nominal economic basis, it would be necessary to:

- tax increases in the nominal value of assets as they accrue and allow a deduction for nominal losses as they accrue;

- allow a deduction only for nominal economic depreciation. In effect, tax depreciation rates would have to be reduced to some extent in accordance with the rate of inflation over the year;
- tax increases in the nominal value of inventories and allow deductions for nominal losses; and
- continue to tax nominal interest income and allow a deduction for nominal interest expense.

Similarly, in order to move the existing tax base onto a real economic income basis, it would be necessary to:

- tax increases in the real value of assets as they accrue and allow deductions for real losses as they accrue;
- allow a deduction for real economic depreciation (i.e. the fall in the real market value of the asset);
- tax increases in the real value of inventories and allow deductions for real losses; and
- tax real interest income and allow a deduction for real interest expense.

Implementation of either a nominal or a real economic income tax base therefore requires the taxation of all forms of income on an accruals basis. In practice, however, it may not be feasible to include all forms of income in the tax base and it may be necessary to continue to tax certain income only when it is realised. The efficiency costs arising from these and any other remaining deficiencies in the income tax system would be less under a real than a nominal income tax base. This is because a real income tax base would ensure that the disparity in the effective tax rates imposed on assets yielding taxable and non-taxable returns would not increase during periods of inflation. Under a nominal income tax base, effective tax rates would tend to increase with increases in the rate of inflation, thereby encouraging increased investment in assets yielding exempt forms of income.

The most appropriate goal for tax reform is therefore a real income tax base since the implementation of such a base would minimise the effect of the income tax system on both the pattern and level of investment and reduce the efficiency costs arising from the remaining deficiencies of the tax base during periods of inflation.

#### **4.4 Objectives of Inflation Indexation**

An approximation to a real income base could be provided by inflation indexation of the existing income base. This would involve adjustments for the effects of inflation on assessable income and deductible expenditure incurred in relation to assets that yield taxable profits on disposal, trading stock, depreciable assets and financial arrangements.

The basic objective of inflation indexation is to replicate the real tax liabilities which would arise in the absence of inflation. This ensures that capital income and expenditure is measured for tax purposes in constant dollar terms, thereby eliminating the effect of inflation on income tax liabilities (or effective tax rates), subject to reasonable administrative and compliance costs. That is, inflation indexation seeks to adjust capital income and expenditure for changes in the purchasing power of money that have occurred since that income and expenditure accrued to the taxpayer. Adjustments for the effects of inflation would be made only at the time the income or expenditure in question is recognised for tax purposes.

It is important to note that indexation by itself would not remedy any of the other deficiencies in the tax base that were identified in Chapter 3. In other words, indexation of the present historical cost tax base would not convert it to a real economic income tax base because lack of an adjustment for inflation is not the only problem with the present tax base. Thus, the current tax base following indexation is best referred to as an "indexed" tax base, not a real income tax base. The latter terminology will be used to mean a real economic income tax base. Similarly, indexation would not change what is assessable or deductible for tax purposes, nor the timing of that assessability or deductibility. It would only change the unit of measurement from historical dollars (or dollars of the day) to constant dollars at the time the income is recognised for tax purposes.

#### **4.5 Selection of an Appropriate Index**

Although indexation is generally accepted as the most appropriate means of adjusting capital income and expenditure for the effects of inflation, considerable debate has arisen over the selection of an appropriate index to use in that process.

As noted above, the objective of inflation indexation is to obtain a better approximation of the real income derived by an entity during periods of inflation by measuring capital income and expenditure in constant dollar terms. The real income derived by an entity is the amount which could be consumed or distributed over a period by that entity while maintaining a constant level of real wealth. The main focus of the debate over the selection of an appropriate index is on the manner in which the real wealth of an entity should be defined. There are two competing approaches. One approach is to

define real wealth in terms of the particular bundle of assets owned by that entity. This approach suggests that an "asset specific" index should be employed when measuring the real income of each entity. The alternative approach suggests that real wealth of an entity should be defined in terms of the command that entity has over goods and services generally. This approach therefore suggests that a "general index" of the prices of goods and services would be more appropriate for the purposes of deflating the nominal income derived by an entity.

#### **4.5.1 Asset Specific Indices : The CCA Approach**

"Asset specific" indices are a feature of the Current Cost Accounting ("CCA") approach to the measurement of real income. Under the CCA approach, real income is defined as the amount which could be consumed or distributed over a period by an entity while keeping that entity's real wealth constant. However, the CCA approach defines the real wealth of the firm in terms of its ability to continue its existing operations (i.e. provide the same output of goods and services). As a result, it seeks to restate the historical cost accounts of an entity in a manner that better reflects the cost of maintaining the current operations of that entity. In order to achieve this result, the CCA approach applies an "asset specific" index to the physical and monetary assets of the entity in order to gain some idea of how the real costs of undertaking its operations have altered over time.

Whatever the merits of the CCA approach for financial reporting purposes, it would be inappropriate (as noted by the McCaw Task Force on Tax Reform) to employ such an approach to calculate income for tax purposes. Its application would reduce the assessable income derived by the taxpayer from any increase in the nominal prices of assets owned by that taxpayer, irrespective of its cause. This includes increases that are due purely to price inflation, as well as price increases that are due to real factors (i.e. where the monetary value of an asset has risen faster than the rate of inflation). Consequently, under the CCA approach, taxpayers would never be required to pay tax on capital income in the form of increases in the real value of their assets. In effect, such an approach suggests that any increase in the relative price of an asset would make the owner of that asset worse off, whereas under a comprehensive income definition, such an increase in the real value of an asset should be included in the assessable income of that taxpayer.

As a result, if the CCA approach were used to measure real income for tax purposes, it would result in the systematic under-taxation of the returns from assets that are expected to increase in real value and the over-taxation of returns assets which are expected to decline in real value.

#### **4.5.2 General Price Index: The CPP Approach**

A preferable approach to the measurement of real income for tax purposes is to employ a general index of the prices of goods and services in the economy,

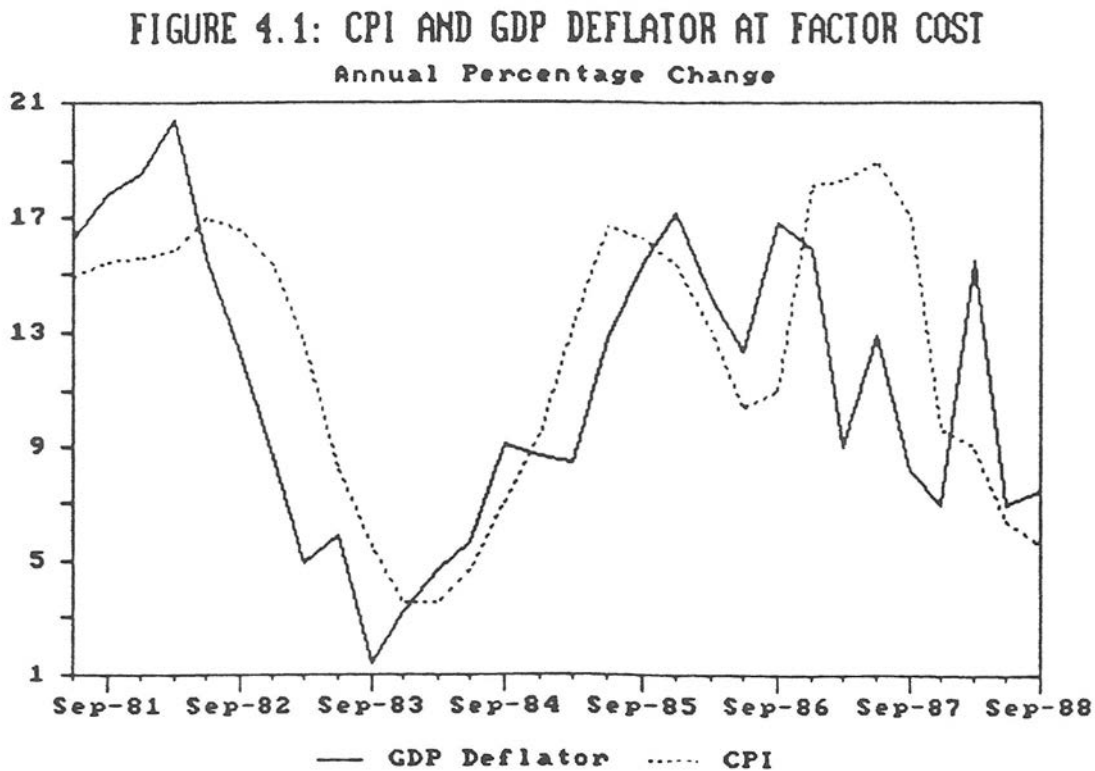
rather than an index of the prices of assets owned by the entity in question. This is because the wealth of an entity is dependent on that entity's command over goods and services in general, and that command will increase whenever the prices of any of the assets it owns rise at a rate faster than the rise in the general price level. This is the indexation methodology that underlies the Current Purchasing Power approach to accounting.

There are a number of possible indices of the general price level available.

### Consumer Price Index

One readily available index of the general price level is the Consumer Price Index ("CPI").

The CPI is a retail price index. That is, it provides a measure of how the prices of final consumer goods and services vary over time. Figure 4.1 indicates how the CPI has varied over the last few years.



The suitability of the CPI as an index to deflate capital income and expenditure has been questioned on a number of grounds. First, the CPI provides only an approximation of the way in which the purchasing power of money changes over time. Since it is clearly impossible to survey the prices of all goods and services when constructing a general index of retail prices, some restriction of the sample size is essential. With respect to the calculation of the CPI, this is achieved by selecting a "basket" of commodities that is representative of the types of goods and services that are consumed by a representative section of the population. The price of each of these commodities is then surveyed and a weighted average is calculated. The weights applied to the price of each commodity reflect the average expenditure per household on each category of commodity plus the expenditure on related commodities, the prices of which are not surveyed. This procedure avoids the need for a complete survey of the prices of all goods and services. However, it also inevitably reduces the accuracy of the CPI as a "cost-of-living" index. The CPI really only measures the manner in which the retail prices of a fixed "basket" of consumer goods and services changes over time.

Other inaccuracies arise because the "basket" of commodities is not continually modified to ensure that it provides a constant level of satisfaction in the face of changes in relative prices, tastes and the quality of commodities. To the extent that consumers shift expenditure away from commodities that experience relatively rapid price increases or the quality of the commodities in the basket improves, the CPI will tend to exaggerate the consequent reduction in purchasing power over time. A downward adjustment to the CPI could be made in order to compensate for this bias. However, it would be difficult to estimate the extent of this bias. There is a danger that the resultant adjustments may lead to greater inaccuracies than the failure to adjust the basket of commodities for these effects.

The time delay between the movement of commodity prices and the construction and publication of the index also presents a number of practical problems for the use of the CPI as a deflator of income and expenditure in respect of capital. The CPI is calculated on a quarterly basis. There is a lag of a approximately six weeks between the end of the quarter and the time the index is published. As a result, if an asset owner recognised capital income or expenditure at the commencement of a quarter, it would be at least ten weeks before that income or expenditure could be indexed in order to calculate the inflation-adjusted amount of tax payable or expenditure deductible. This constrains the frequency with which capital income and expenditure can be adjusted for the effects of inflation.

The suitability of the CPI has also been questioned on the grounds that it reflects the indirect taxes that are levied on the goods and services it covers. Consequently, if the CPI were used to index capital income and expenditure and the rate of GST or the rates of excise duties (e.g. on beer, cigarettes, etc.)

were increased, the resultant increase in the CPI would reduce the amount of revenue the Government collects from the taxation of capital income. Conversely, any reduction in GST or excise taxes would increase the revenue raised from the taxation of capital income. That is, the use of the CPI to index capital income and expenditure will tend to erode the effectiveness of indirect taxes as fiscal instruments. This suggests that it might be more appropriate to either adjust the CPI to eliminate the effects of tax policy changes, or to employ an alternative price index that does not vary with changes in indirect taxes for the purposes of deflating capital income and expenditure.

### **Gross Domestic Product Deflator**

One such alternative is the index of the price of Gross Domestic Product ("GDP") at "factor cost". As illustrated in Figure 4.1, the manner in which this index has varied over the last few years differs to some extent from that of the CPI. These differences arise from two important sources. First, the index of the price of GDP at factor prices includes a broader range of goods and services than the CPI. In addition to the prices of final consumer goods and services, it also includes the prices of goods and services purchased by the Government for public use as well as the prices of capital goods and services that are used as intermediate inputs into the production of other goods and services. Second, it attempts to value these goods and services at "factor cost" rather than at market prices. That is, it attempts to exclude the effect of indirect taxes on commodity prices. As a result, the price of GDP at factor cost can be expected to rise in relation to the CPI if there is a fall in the real value of indirect taxes; a reduction in the price of imported goods relative to domestically produced goods; a rise in the price of capital goods in relation to consumer goods; or a rise in the price of goods and services purchased by the Government relative to to the price of goods and services bought for private consumption.

It is not clear that it is necessary to incorporate the prices of capital goods and services into a price index that is intended to reflect changes in the purchasing power of money. Although price inflation increases the prices of such goods and services, it is really only final consumption that is relevant in determining the satisfaction that an individual derives from money income. Investment in capital assets is not an end in itself. Rather it is an indirect means of increasing future consumption of final goods and services. Thus, an index of consumption prices provides a more appropriate basis for assessing the purchasing power of money income.

The assumptions underlying the calculation of the price of GDP at factor cost also cast doubts on the extent to which the index is invariant with changes in tax policy. The index is constructed on the assumption that only indirect taxes are shifted forward onto consumers and cause the prices of goods and services



to change. Direct taxes are assumed to affect factor returns rather than market prices. These assumptions are somewhat unrealistic. As a result, although GDP at factor cost is potentially less responsive to changes in indirect taxes than the CPI, it will still tend to vary in response to reform of direct taxes.

Even if it were possible to obtain a general price index that was invariant with changes in tax policy, it is far not clear that such an index would be appropriate for the purposes of inflation indexation. Although such an index might preserve the effectiveness of taxes as revenue raising instruments, it would do so at the expense of the efficiency of the tax system. In the absence of indexation, inflation is a form of taxation. Under a nominal income tax, an increase in the rate of GST would not only increase government revenue by increasing the prices of consumer goods and services, but it would also result in a "windfall" increase in the revenue collected from the taxation of capital income. This is because any increase in the rate of price inflation, regardless of its source, will have the effect of increasing the effective tax rate on capital income. Under an indexed income tax, however, a GST induced increase in the CPI would not affect the effective tax rate on capital income, albeit at the expense of a reduction in tax revenue relative to the revenue that would have been raised under a nominal income tax. Thus, although the use of the CPI to index capital income and expenditure may result in a reduction in the amount of tax revenue raised by a given rise in GST, it collects that revenue in a more efficient manner than would have been the case in the absence of such indexation.

A further problem associated with the use of an index of the price of GDP at factor cost is its availability. At the moment, there is approximately a two year delay in the publication of national accounts data. As a result, considerable resources would have to be shifted into reducing that delay before it would be practicable to employ a GDP deflator for tax purposes.

In summary, it does not appear to be either desirable or feasible to employ an index of the price of GDP at factor cost to adjust capital income for the effects of inflation. The more appropriate general price index to employ for the purposes of inflation indexation is the CPI.

## 4.6 Conclusion

The tendency of the current income tax system to overtax capital income and distort patterns of investment during periods of inflation can be largely attributed to the "historical cost" nature of the capital income base. Capital income and expenditure are measured for tax purposes in current rather than constant dollar terms. For example, profits realised on the sale of assets are measured relative to their historical cost and depreciation deductions are based on the historical costs of depreciable assets.

In principle, these tax-induced distortions in the pattern of investment during periods of inflation could be eliminated by moving the existing income tax system onto either a real or a nominal basis. Under a nominal income base, however, tax liabilities would depend on the rate of inflation. The most appropriate goal for future reform is, in principle, a real income tax base.

In practice, an approximation to a real income base could be achieved by a comprehensive indexation of capital income and expenditure for the effects of inflation. This would involve indexation of assets that yield taxable profits on disposal, trading stock, depreciable assets and financial arrangements. The most appropriate index for this purpose is the Consumer Price Index. The resultant series of adjustments would be consistent with those proposed under the Current Purchasing Power accounting system.

"Asset specific" indices, such as those employed under the Current Cost Accounting approach, would be entirely unsuitable for tax purposes. Such an approach to the measurement of real income would favour investment in assets that are expected to appreciate in real terms and penalise investment in assets that are expected to decrease in real value.

The implications of comprehensive indexation for the neutrality of the tax system, administrative and compliance costs, tax avoidance and government revenue are examined in Chapters 5 to 9.

# CHAPTER 5: INDEXATION OF ASSESSABLE GAINS

## 5.1 Introduction

Having outlined in the previous chapter the objectives of inflation indexation and identified the best index, it is now appropriate to consider the feasibility of comprehensively indexing the capital income base.

This chapter examines the manner in which assessable income realised on the sale of an asset could be indexed for the effects of inflation. It examines the extent to which indexation would improve the neutrality of the income tax system and its implications for administrative and compliance costs. Chapters 6 to 8 then examine the mechanics of indexing trading stock, depreciable assets and financial arrangements from a similar perspective.

For the purposes of the analysis undertaken in each chapter, it is assumed that all other forms of capital income are subject to indexation.

## 5.2 Mechanics of Indexation

As noted in Chapter 3, inflation alters the effective tax rates on assessable income realised on the sale of assets. In this case assessable income is calculated as the difference between the consideration received on disposal less the original cost of the asset (ignoring selling costs). Since the cost of the asset is its historical cost while its sale price will usually rise with inflation, it is clear that the seller's tax liability will also rise with inflation.

This effect can be eliminated by indexing the historical cost of the asset for the inflation that has occurred since that asset was purchased. The objective is to state the cost of the asset in dollars with the same purchasing power as the dollars of the period in which the asset is sold. Each item of capital expenditure that has been incurred by the taxpayer over the ownership period would also be indexed. This could be achieved in practice by multiplying each item of expenditure by an indexation factor.

The indexation factor for each item of expenditure would be the amount equal to the "index number" for the period of the year in which the asset was disposed of divided by the index number for the period of the year in which the capital expenditure was incurred. These index numbers would be published by the Inland Revenue Department and would be based on the Consumer Price Index ("CPI") published by the Government Statistician. The CPI is currently available on a quarterly basis, and the Inland Revenue Department could publish index numbers for each quarter of the year.

The indexed original cost and capital expenditures would then be summed to determine the "indexed cost" of the asset. The net taxable income derived on the disposal of the asset would be calculated by subtracting its indexed cost from any consideration received on the disposal of the asset.

There are three approaches taxpayers could employ to implement this indexation methodology:

- defer the calculation of the indexed cost of the asset until it is disposed of;
- calculate the indexed cost of the asset on an annual basis; or
- calculate the indexed cost of the asset every indexation period (e.g. quarterly if index numbers are published for each quarter of the year).

### **5.2.1 Calculation of the Indexed Cost of the Asset on Disposal**

Individual taxpayers who own a limited range of non-depreciable assets for relatively long periods of time and who do not expect to undertake frequent capital improvements to those assets may prefer to record the date of purchase of the asset and its cost, as well as the dates and costs of any subsequent capital improvements, and defer the calculation of the indexed cost of the asset until it is disposed of in whole or in part.

This approach can be illustrated by reference to the following example. For the purposes of the example, it is assumed that the asset is purchased at the end of a quarter, that any subsequent capital expenditure is also incurred at the end of a quarter and that the asset is sold at the end of a quarter. Although these assumptions are unrealistic, they simplify the presentation of the basic mechanics of indexation. Section 5.2.2 examines the mechanics of indexation under the more realistic assumption that assets are purchased, sold and subjected to capital improvements on dates that do not coincide with the commencement or the end of indexation periods (i.e. quarters).

#### **Example**

Consider the case of a taxpayer who acquires a block of land on 31 March 1980 (i.e. at the end of the March 1980 quarter) for \$100,000 and undertakes capital improvements to that asset on 30 June 1980 (i.e. at the end of the June 1980 quarter) and 30 September 1981 (i.e. at the end of the September 1981 quarter) which cost \$10,000 and \$20,000 respectively. The asset is subsequently sold for \$200,000 on 31 December 1981 (i.e. at the end of the December 1981 quarter).

The index numbers for the relevant quarters are:

March 1980	100.0
June 1980	103.6
September 1981	124.1
December 1981	128.2

The first step is to calculate the indexation factors (rounded to 3 decimal places) to be applied to each item of expenditure. This is achieved in the following manner:

<b>Expenditure Item</b>	<b>Index Factor</b>	
Original cost	128.2/100	= 1.282
Capital improvement (June 1980)	128.2/103.6	= 1.237
Capital improvement (September 1981)	128.2/124.1	= 1.033

The next step is to apply those indexation factors to each item of expenditure in order to express the expenditure in December 1981 dollars and thereby determine the indexed cost of the asset. This is achieved as follows:

$$\begin{aligned}
 \text{Indexed cost} &= \text{Indexed original cost of asset} + \text{Indexed cost of capital improvements} \\
 &= \$100,000 \times 1.282 \\
 &\quad + \$10,000 \times 1.237 \\
 &\quad + \$20,000 \times 1.033 \\
 &= \$128,200 \\
 &\quad + \$12,370 \\
 &\quad + \$20,660 \\
 &= \$161,230
 \end{aligned}$$

The taxable income on sale can then be calculated in the following manner:

Proceeds from disposal	\$200,000
Less: Indexed Cost	\$161,230
<b>Taxable income</b>	<b>\$ 38,770</b>

The approach outlined above may not be suitable for taxpayers who either undertake frequent improvements to capital assets, or who report the book values of their assets on a regular basis (e.g. business taxpayers). Such taxpayers may find it preferable to update the original cost of their assets on an annual or even a quarterly basis.

### **5.2.2 Indexation of Assets Held for Part of a Quarter**

So far, it has been assumed that the asset in question has been purchased, sold and subjected to capital improvements at the end of an indexation period. This assumption ensures that assets are not held for part of an indexation period (i.e. the ownership period is an exact multiple of an indexation period).

In practice, assets will tend to be purchased, sold and subjected to capital improvements on dates that fall somewhere within particular quarters. As a result, assets will be held for only a fraction of the quarters in which they are purchased or sold and capital improvements will only apply for a fraction of the quarter in which they were incurred. This raises the issue of the appropriate indexation treatment of the period of ownership of an asset that spans part of a quarter.

It would be possible to prorate indexation for the number of days an asset is held in the year it is acquired and make similar adjustments to other cash flows but such an approach would tend to increase compliance costs by increasing the complexity of the indexation calculations.

In view of these compliance costs and the fact that most of the assets that produce taxable gains on sale are investment assets that are typically held for periods in excess of one year, a preferable approach would be to require taxpayers to use the index number of the first full quarter for which an asset is held rather than to prorate the index number. That is, when calculating the appropriate indexation factor to apply to the original cost of the asset, the taxpayer would divide the index number for the quarter in which the asset is sold by the index number for the first full quarter in which the asset is held. Although this approach would reduce the indexation adjustment in some cases, it would also substantially reduce compliance costs for the bulk of taxpayers who hold assets for several years. As discussed in Chapter 9, a further benefit of this approach is that it would help reduce the extent to which the indexation provisions could be abused by taxpayers to reduce their tax liabilities.

### **5.2.3 Imputation and the Indexation of Income Derived from the Sale of Shares**

The indexation procedures would be used by both individuals and companies to adjust the assessable income they derive from the sale of an asset for the effects of inflation. Companies, however, would be able to pass credits through to shareholders for any tax paid on indexed income. In addition, shareholders would also be able to apply the indexation procedures outlined above to adjust the assessable income they realise on the sale of shares for the effects of inflation. No changes would be required to the imputation system. This process is illustrated in the following example.

## Example

Consider the case of a company with one shareholder that purchases a block of land on 1 April 1980 (i.e. at the beginning of the June 1980 quarter) for \$100,000 with the intention of deriving a profit on the sale of that land. The land is eventually sold on 1 January 1982 (i.e. at the commencement of the March 1982 quarter) for \$200,000 and the after-tax profit is fully distributed to the shareholder as is the credit for the company tax paid. It is assumed that the marginal tax rate of the shareholder is the same as the company tax rate (i.e. 33%). Following the receipt of the dividend, the shareholder then sells the shares in the company.

The index numbers for the relevant quarters are:

June 1980	100.0
March 1982	128.2

## Company

The indexed income derived by the company on the sale of the land and the after-tax dividend payable to the shareholder are calculated in the following manner:

Proceeds from disposal of land	\$200,000
Less: Indexed cost (\$100,000 x 1.282)	\$128,200
<b>Taxable income</b>	<b>\$ 71,800</b>
Company tax @ 33%	\$ 23,694
<b>After-tax profit</b>	<b>\$ 48,106</b>

The after-tax profit is paid to the shareholder in the form of a dividend. The value of the gross dividend (i.e. the dividend inclusive of imputation credits) is:

Gross dividend	=	Dividend	+	Tax credit
	=	\$48,106	+	\$23,694
	=	\$71,800		

The initial value of the shareholder's share in the company can be assumed to be the same as the value of the land, that is, \$100,000. However, following payment of company tax on the profit from the sale of the land and the distribution of the dividend to the shareholder, the value of the share is assumed to be as follows:

Value of share on 1 January 1982	=	Original value	-	Company tax	-	Dividend paid
	=	\$200,000	-	\$23,694	-	\$48,106
	=	\$128,200				

### Shareholder

The after-tax dividend income received by the shareholder is calculated as follows:

Gross dividend	\$71,800
Less Tax @ 33%	\$23,694
	<b>\$48,106</b>
Plus Tax credit	\$23,694
<b>After-tax dividend income</b>	<b>\$71,800</b>

The tax payable on the income derived from the sale of the share is calculated as follows:

Consideration received on disposal of share	\$128,200
Less: Indexed cost base (\$100,000 x 1.282)	\$128,200
<b>Taxable income on disposal</b>	<b>0</b>

Hence, in this example, no tax would be payable by the shareholder in respect of either the dividend income or income derived on disposal of the shares. As a result of the imputation system, the corporate and shareholder level taxes are integrated, even when profits on sale of assets are indexed for inflation.

If, however, the income from real assets is indexed while interest income and expenses are not, a somewhat different approach to the indexation of the income realised on the disposal of shares might be required. This issue is discussed in Chapter 10.

#### 5.2.4 Partial Sale of Assets

The treatment of partial sales of assets that yield taxable profits on sale is discussed in Chapter 15. Under the approach outlined in Chapter 15 expenditure is apportioned between the part of the asset disposed of and the part retained. Expenditure which is apportioned to the part of an asset sold should be indexed for inflation. This expenditure would be indexed in exactly the same way as in previous examples.



### 5.2.5 Division, Combination and Changes in the Nature of Assets

Not all assets maintain their character over their economic lives. It is not uncommon for an asset to be divided up into two or more assets (e.g. a block of flats originally owned by one person that is subsequently divided up into a number of strata title units), for two or more assets to be combined to form a new asset, or for an asset to be modified to such an extent that it changes its nature.

Sometimes these transformations will result in a recognition of accrued income, whereas in other instances they will not. In either case, there is little change required to current procedures to facilitate indexation of that income. The only difference under an indexed system is that the book value employed for the purposes of the calculations would be the indexed cost rather than the historical cost of the asset.

For example, where asset transformations do not result in the recognition of income, the indexed cost of the asset at the time of the transformation would be apportioned to each of the new or modified assets that have been created by the transformation in the same manner as is the current historic cost base. This would ensure that on the sale of the new asset, all of the capital expenditures incurred in the process of creating the asset have been adjusted for the effects of inflation since they were originally incurred, even though they were occurred prior to the creation of the asset. Where the original asset continues to exist either in whole or in part after any of the transformations described above, then the indexed cost of the asset would be calculated as if such transformations had not occurred. The indexed cost would, however, be reduced by the amounts of indexed cost that have been transferred to the new assets.

### 5.2.6 Treatment of Involuntary Disposals

Where a depreciable asset is irreparably damaged, insurance receipts are deemed to be assessable income. Where the receipts are for repairable damage, amounts in excess of the expenditure incurred in making good the repair are, in general, non-assessable but are subtracted from the property's cost.

#### **Example**

Consider the case of a taxpayer who acquires an asset on 1 April 1980 for \$100,000. On 30 June 1981, the asset is damaged and the cost of repairs is \$20,000 which is recovered from an insurance company. These repairs are conducted in September 1981. The asset is sold in March 1982 for \$200,000.

The index numbers for the relevant quarters are:

June 1980	100.0
June 1981	119.8
September 1981	124.6
March 1982	133.6

The first step is to calculate the indexed cost of the asset at the time the insurance receipt is derived:

$$\begin{aligned} \text{Indexed cost of asset at the time} &= \$100,000 \times \frac{119.8}{100} \\ \text{the insurance proceeds are received} &= \$119,800 \end{aligned}$$

The next step is to deduct the insurance proceeds received from the indexed cost base to calculate the new indexed cost of the asset:

$$\begin{aligned} &= \text{Indexed cost in June 1981} && - && \text{Insurance proceeds received in June 1981} \\ &= \$119,800 && - && \$20,000 \\ &= \$99,800 \end{aligned}$$

The cost of repairs conducted in September 1981 would be added to the indexed cost. The new indexed cost would be:

$$\begin{aligned} \text{Indexed cost in September 1981} &= \text{Indexed cost prior to repairs} + \text{Cost of repairs} \\ &= (\$99,800 \times 124.6/119.8) + \$20,000 \\ &= (\$99,800 \times 1.040) + \$20,000 \\ &= \$123,799 \end{aligned}$$

The taxable income derived from the sale of the asset can be calculated as follows:

$$\begin{aligned} \text{Taxable income} &= \text{Sale proceeds} && - && \text{Indexed cost in March 1982} \\ &= \$200,000 && - && (\$123,799 \times 133.6/124.6) \\ &= \$200,000 && - && (\$123,799 \times 1.072) \\ &= \$67,259 \end{aligned}$$

### 5.3 Treatment of Capital Losses

In principle, under an indexed income tax system, taxpayers should be able to claim a deduction for real losses due to any excess of the indexed cost over the consideration received on the disposal of an asset.

Restrictions on the deductibility of real losses are usually imposed where the entire tax base is not indexed for the effects of inflation. In particular, real loss restrictions typically seek to ensure that indexation is not indirectly extended to interest expense. For example, in Australia taxpayers are first required to determine whether a real gain has been realised by subtracting the indexed cost of the asset from the consideration received on disposal. If there is no real gain or a real loss, the taxpayer must calculate whether a nominal gain or loss has been realised by subtracting the unindexed cost from the consideration received. If a nominal gain has been realised, there is no tax liability. However, if there is a nominal loss, then the loss is deductible. This procedure ensures that only the real component of nominal gains is subject to tax and only the nominal component of real losses is deductible.

Even if such a limitation on real losses succeeds in achieving its objectives of reducing the scope for tax avoidance, it does so at the expense of increasing the inefficiency and complexity of the income tax system. Limitations on real losses can distort patterns of investment by deterring investment in assets that may produce a real losses since those real losses would not be deductible. In addition, restrictions on the deductibility of real losses would tend to lock investors into holding assets with accrued real losses since any marginal gains would be tax free so long as there are accumulated real losses. Since relatively risky investments are more likely to yield real losses, real loss limitations are likely to discourage risk-taking.

In summary, provided the scope for tax avoidance can be minimised, real losses should be deductible just as real income is assessable.

### 5.4 Neutrality

If indexed rather than nominal income were taxable on sale, the effective tax rate on the sale of assets would be independent of the rate of inflation. Table 5.1 below shows the effective tax rates on the real income derived on the sale of an asset. It is assumed that the real pre-tax rate of return on the asset is 10% per annum and that the statutory tax rate is 33%. For comparison, the effective tax rates on real income under an unindexed system are also shown.

**Table 5.1**  
**Effective Tax Rates on Real**  
**Profits Derived on the Disposal of Assets**

Holding Period (years)	Unindexed			Indexed
	Inflation Rate			
	0%	5%	10%	
1	33	49	63	33
5	29	40	49	29
10	25	31	36	25
15	21	25	27	21
20	18	20	21	18
25	16	17	17	16
30	14	14	15	14
35	12	12	13	12
40	11	11	11	11
45	10	10	10	10
50	9	9	9	9

As shown in the table, the effective tax rates on realised profits under an indexed system are the same as the rates that would apply in the absence of inflation. It is important to note, however, that due to the effects of deferral of tax until realisation, the effective tax rates under both the unindexed and the indexed systems are closely similar for holding periods in excess of 25-30 years.

## 5.5 Administrative and Compliance Costs

The process of inflation indexation described above would be relatively straightforward for taxpayers to apply and is unlikely to significantly increase administrative and compliance costs.

The compliance costs associated with indexation would largely depend on the approach adopted by taxpayers to calculate the indexed cost of their assets.

For example, taxpayers could simply keep a record of the date on which assets are originally acquired, their prices, as well as the dates and amounts of capital expenditure subsequently incurred in relation to the assets. The calculation of the indexed cost of the asset could then be deferred until assets are sold. This approach is probably the most suitable for taxpayers who purchase non-depreciable assets with the intention of holding them in the longer term and who do not expect to be making frequent capital improvements to the asset over the ownership period.

Businesses which own a wide variety of depreciable assets may find it simpler to update the indexed cost of their assets on either an annual or quarterly basis. This would ensure that only one indexation factor would have to be applied to the indexed cost figures for the previous year or quarter in order to calculate the indexed cost of all assets in the next period. If the indexed cost of all assets were updated on a quarterly basis, any capital expenditure incurred in relation to an asset during the quarter could simply be added to the indexed cost base.

## **5.6 Conclusion**

Assessable income realised on the disposal of an asset could be adjusted for the effects of inflation by indexing the original cost of the asset and the cost of any subsequent capital improvements for inflation since the capital expenditure was incurred. Although this would not eliminate the advantages taxpayers could derive from investing in those assets and deferring their tax liabilities, it would ensure that the effective tax rates applying to such income do not vary with inflation.

This process of indexation is relatively straightforward and is unlikely to significantly increase administrative and compliance costs. Taxpayers would have considerable flexibility to reduce their compliance costs by adjusting the frequency with which they calculate the indexed cost of their assets (e.g. quarterly, annually or at the time of sale).



# CHAPTER 6: INDEXATION OF TRADING STOCK

## 6.1 Introduction

Inflation can significantly alter the effective rates of tax applying to income derived from trading stock as was discussed in Chapter 3. This chapter examines how assessable income from trading stock could be adjusted for the effects of inflation and analyses implications of indexation for neutrality of the income tax system and administrative and compliance costs.

## 6.2 The Nature of Trading Stock

It is useful to consider first the nature of trading stock and its current tax treatment since these factors are influential in the selection of an appropriate indexation methodology.

Trading stock is defined in section 85(1) of the Income Tax Act to include anything that is:

- produced or manufactured; and
- acquired or purchased for the purposes of manufacture, sale or exchange; and
- livestock; and
- anything on which expenditure is incurred after 23 October 1986 which would be trading stock if possession were taken.

Land and any part of land (e.g. fruits of the soil such as vegetables, trees, soil and minerals) is excluded from the definition of trading stock. Although debt instruments which constitute financial arrangements under section 64B of the Income Tax Act are also excluded from the definition of trading stock if they are subject to the accrual provisions outlined in sections 64B to 64M of the Act, certain bank debts acquired by dealers in shares and securities have been classified as trading stock. For the purposes of this chapter, however, it will be assumed that trading stock excludes all debt instruments. The indexation of debt instruments is examined in Chapter 8.

Trading stock is similar in many respects to the assets discussed in Chapter 5 which produce assessable gains on sale. All of these assets produce assessable income on sale and deductions are allowed for their cost. For example, shares and other property acquired for the purpose of making a profit on sale may be taxable in the hands of individual investors in the manner outlined in Chapter 5, while identical assets in the hands of dealers in shares or other property may be treated as trading stock.

There are, however, two general differences between trading stock and the assets discussed in Chapter 5:

- it is often extremely difficult, if not impossible, to distinguish between different units of trading stock. Although businesses which carry only small quantities of stock with high unit values may find it both desirable and feasible to keep track of the purchase and sale prices of individual units of stock, this will usually be impossible for taxpayers holding large volumes of identical units of trading stock with low unit values (e.g. the raw material inputs used by many manufacturing industries); and
- unlike the assets referred to in Chapter 5, trading stock is not normally purchased as a long term investment. Although expectations of increases in the value of trading stock do influence the stockholdings of some businesses (e.g. share dealers), the primary reason for holding stocks is to ensure a ready supply of goods to meet fluctuations in the demand (e.g. to avoid transportation delays). There are substantial costs and risks associated with holding stocks of assets, including possible deterioration, damage and changes in consumer tastes. These costs are typically minimised by minimising stock levels as well as the stockholding period.

In recognition of these differences, the income tax system has a specific regime for the calculation of assessable income for trading stock. Each year, taxpayers are assessable on any variation in the value of the trading stock. In practice, this is achieved by allowing a deduction for the value of opening stock and including the value of closing stock in assessable income.

The value of trading stock at the beginning of a year is equivalent to its value at the end of the preceding year (except in the case of a business that has commenced trading during the year, in which case opening stocks are valued at the cost price of the trading stock purchased in that initial year).

Taxpayers have the option of valuing trading stock at its cost price, current market value or replacement cost. Special valuation methodologies are also available for certain types of stock (eg livestock). The same valuation methodology need not be applied to all trading stock held by the taxpayer, but it must be applied consistently.



Valuation of stock at cost is a relatively straightforward process for some types of stock (e.g. high-unit value, low-turnover items) but not others. For this reason, taxpayers are allowed to employ a range of general methods for determining the cost of stock on hand, including:

- "first-in, first-out" ("FIFO"). This method assumes that each unit of stock is disposed of in the order in which it was acquired. That is, the first unit acquired is assumed to be the first unit sold and so on. Closing stock is therefore valued at the cost of the most recently acquired units;
- average cost. This approach involves adding the cost of any stock purchased in the year to the cost of opening stock and calculating the average unit cost of the stock. This is used to value the cost of any stock sold or consumed. This approach is employed by some manufacturers who retain stocks of raw material inputs for lengthy periods of time;
- standard costs. Under this method, the cost of closing stock is determined by reference to a predetermined standard unit cost; and
- adjusted selling price. This method involves the determination of the cost of closing stock by reducing the retail selling prices of stock by an amount equal to the normal gross profit margin. It is typically employed by businesses where retail price lists are readily available.

Taxpayers who elect to value their stock at market value rather than at cost must determine the amount that their trading stock could be sold for in the normal course of business on the last day of the income year. This method is often applied in circumstances where the value of stocks on hand may fall due to deterioration, obsolescence, damage or changes in fashion.

Alternatively, taxpayers who elect to value stock at replacement cost must determine the cost of replacing the stock at balance date. Ordinarily, this is the purchase cost of the goods on that date except where it would have been necessary to order the stocks at an earlier date to secure supply by the balance date. In that instance, stocks are valued at their cost at the time of the order.

In summary, regardless of the method employed by taxpayers to determine the value of trading stock, the tax system treats trading stock as if it were one asset. Each year, the cost of any expenditure incurred in acquiring additional stock is deductible and any income derived from the sale of trading stock is assessable. In reality, however, the trading stock that a business has on hand at any point in time is comprised of a range of assets that have been purchased at different dates in either that or earlier financial years. Stock will also be sold at different dates in either that year or subsequent income years.

## 6.3 Indexation Methodologies

Any method of indexation that is applied to trading stock needs to be compatible not only with the nature of trading stock and its existing tax treatment, but also with the indexation methodologies proposed for the income derived from other assets. Various indexation methods are outlined below. They are evaluated from the point of view of their ability to improve the neutrality of the tax system during periods of inflation and their implications for administrative and compliance costs.

### 6.3.1 Indexation of Individual Units of Trading Stock

As noted in section 6.2, in some cases individual units of trading stock are readily identifiable and it is feasible for taxpayers to keep detailed records of the purchase and sale dates as well as the value of each unit of stock on those dates (e.g. consumer goods with high unit values). In these circumstances, it would be possible, in principle, to employ an indexation methodology similar to that outlined in Chapter 5. The cost of each unit of trading stock would be indexed for the effects of inflation over the period it is held. That is, profit on the sale of each unit of stock could be computed as:

$$\text{sale proceeds} - \text{indexed cost.}$$

In view of the fact that trading stock is often held for relatively short periods of time, it would be necessary to employ daily indexation factors for the purposes of calculating the indexed cost of each item of trading stock. Since the CPI is currently available only on a quarterly basis, this would require some daily apportionment of those quarterly index numbers as discussed in Chapter 5. Application of the indexation methodology proposed in Chapter 5 for assets which produce assessable profits on sale would be inappropriate since it would effectively deny indexation to businesses which turn over their trading stock more frequently than once a quarter. This would discriminate against businesses with rapid stock turnover.

The effects of inflation on trading stock that is held for relatively short periods of time might appear to be relatively insignificant during periods of moderate inflation. However, this is only the case if stock is not replaced. Where a constant pool of trading stock is maintained over the year and the stock is turned over frequently, the denial of indexation for stocks held for less than a full quarter would in effect deny indexation for the entire value of trading stock held over the year.

For other types of trading stock, it is not always feasible for taxpayers to keep track of the purchase and sale dates of each item of stock. For these types of trading stock, the selection of an appropriate indexation methodology is constrained by the manner in which the trading stock is currently valued. Taxpayers who currently value trading stock on a FIFO basis could employ the

indexation methodology described above, even though it may not be feasible to identify individual units of trading stock. This is because taxpayers have to keep records of the date and cost of stock purchased and the dates and cost of stock sold in order to be able to apply the FIFO method.

### 6.3.2 Index Trading Stock as One Asset

Rather than index each item of trading stock for the effects of inflation, an alternative approach would be to treat trading stock as one asset and adjust the income derived from that asset each year for the effects of inflation over that year. As noted in section 6.2, income from trading stock is currently calculated as follows:

	Sales revenue
plus	Value of closing stock
less	Expenditure on purchases
less	Value of opening stock

Other expenses of running a business, such as salaries and wages are also deductible but are not considered here.

Since all of these amounts are currently expressed in nominal dollars, in principle each would have to be adjusted for the effects of inflation in order to ensure that all income and expenditure incurred in relation to trading stock is valued in end of year dollars. In practice, however, it is really only feasible to provide an adjustment for the effects of inflation on the value of stocks held over the year. The compliance costs associated with indexing sales revenue and the cost of purchases for the effects of inflation would be prohibitive.

There are a number of possible approaches to adjusting the value of trading stock for the effects of inflation.

One possible approach is to provide taxpayers with a deductible "inflation adjustment" for the effects of inflation on the average value of trading stock held over the accounting year. There are a number of possible variants of this approach depending on the manner in which the average value of stocks is estimated. These include:

- indexing opening stock. This method employs the value of opening stock as a proxy for the average value of stock held over the period. It involves the adjustment of opening stock for the effects of inflation over the entire accounting year;
- indexing the average of the opening and closing stocks. This method seeks to obtain a more accurate estimate of the stock level over the accounting year by calculating a simple average of opening stock and closing stock and then adjusting this amount for the effects of inflation; and

- indexing the average stock level during the year. This method would involve calculating a quarterly or monthly average of the value of stock (in either current or end of year dollar terms) and the adjustment of this amount for the effects of inflation over the year.

In each case, the inflation adjustment involves multiplying the average value of stocks by the inflation rate over the period. Under each of the approaches, it is important to ensure that stock on hand at the end of the year which has been held for a significant period of time is valued in end of year dollars. Any method that achieves this would be acceptable including market value, replacement cost, or standard cost. Moreover, if stock is valued on a FIFO basis and turns over rapidly, its costs when acquired would normally provide a reasonable measure of its cost in end of year dollars. If, however, the stock turns over slowly, it would be necessary to adjust the value of those stocks for the effects of inflation between the dates of purchase of those stocks and the end of the accounting year.

Another approach, which is sometimes seen as a substitute for indexation, is to calculate the cost of stock on hand at balance date on a "last-in, first-out" ("LIFO") basis. The effect of this rule is that the cost of stock on hand is always taken to be the cost of the first unit(s) of stock purchased.

The mechanics of each of these indexation methodologies can be illustrated by reference to the following example.

### Example

Assume that a taxpayer acquires 100,000 units of trading stock for \$1 per unit on 31 March 1980. The value of opening stock on 1 April 1980 is therefore \$100,000. Assume also that at the end of each subsequent quarter, the taxpayer sells 25,000 units of trading stock and uses the proceeds to purchase another 25,000 units. That is, a constant quantity of 100,000 units of trading stock is maintained throughout the year. The nominal values of these sales and purchases under conditions of 0% and 2% inflation are as follows:

Date	Value of Stock			
	Inflation = 0%		Inflation = 2%	
	Purchases	Sales	Purchases	Sales
	\$	\$	\$	\$
31 Mar 1980	100,000.00	0	100,000.00	0
30 Jun 1980	25,000.00	25,000.00	25,500.00	25,500.00
30 Sep 1980	25,000.00	25,000.00	26,010.00	26,010.00
31 Dec 1980	25,000.00	25,000.00	26,530.20	26,530.20
31 Mar 1981	25,000.00	25,000.00	27,060.80	27,060.80

If stocks were valued on a FIFO basis, the composition and value of closing stock as at 31 March would be as follows:

	<b>Value of Stock</b>	
	Inflation = 0%	Inflation = 2%
25,000 units purchased on 30 June 1980	25,000.00	25,500.00
25,000 units purchased on 30 September 1980	25,000.00	26,010.00
25,000 units purchased on 31 December 1980	25,000.00	26,530.20
25,000 units purchased on 31 March 1981	25,000.00	27,060.80
Closing stock as at 31 March 1981	100,000.00	105,101.00

Alternatively, if the stock was valued at replacement cost, the value of closing stock as at 31 March would be \$108,243.22.

Taxable income derived from trading stock for the year ending 31 March 1981 would be calculated as follows (assuming stocks are valued on a FIFO basis):

	<b>Value of Stock</b>	
	Inflation = 0%	Inflation = 2%
	\$	\$
Sales revenue	100,000.00	105,101.00
plus Closing stock	100,000.00	105,101.00
less Purchases	100,000.00	105,101.00
less Opening stock	100,000.00	100,000.00
Taxable income	0	5,101.00

That is, in the absence of inflation indexation, the taxpayer in this instance would be overtaxed by \$5,101 since in the absence of inflation the taxpayer would not have derived any assessable income.

The various indexation methodologies which could be employed to reduce the effects of inflation on the assessable income produced by trading stock are illustrated below by reference to the above example.

## Index Opening Stock

This method uses the value of opening stock as a proxy for the average value of stock on hand throughout an income year. Regardless of the manner in which trading stock is valued, this method would calculate the inflation adjustment by multiplying the opening cost of trading stock by the rate of inflation over the year. Quarterly index numbers could be employed for this purpose. This inflation adjustment would be calculated as follows:

$$\text{Inflation adjustment} = \text{Opening cost} \times (A - 1)$$

where:

$$A = \frac{\text{Index number for end of accounting period}}{\text{Index number for end of preceding accounting period}}$$

In the case of the example under consideration, the inflation adjustment would be \$8,243.22.

A deduction would then be allowed for this inflation adjustment in calculating taxable income.

The calculation of taxable income is outlined below under the assumptions that closing stocks are either valued on a replacement cost or FIFO basis.

		FIFO Basis	Replacement cost
	Sales revenue	\$105,101.00	\$105,101.00
plus	Closing stock	\$105,101.00	\$108,243.22
less	Purchases	\$105,101.00	\$105,101.00
less	Opening stock	\$100,000.00	\$100,000.00
less	Inflation adjustment	\$8,243.22	\$8,243.22
	Taxable income	- \$ 3,142.22	\$0

This methodology would be relatively simple for most taxpayers to apply, including those who value their closing stock at average cost, standard cost, adjusted selling price, market value or replacement cost.

As illustrated above, however, the simplicity of this methodology is achieved at the expense of some inaccuracy in the adjustment to opening stocks for the effects of inflation. In this instance, it results in the under-taxation of income from trading stock when trading stock is valued on a FIFO basis. This inaccuracy arises because the stock on hand at the end of the income year is valued in dollars at the time the stock was purchased rather than end of year dollars.

In order to accurately adjust income from trading stock that is valued for tax purposes on a FIFO basis, it would be necessary to adjust the value of all units of stock held at the end of the accounting year for the effects of inflation since the dates of purchase of that stock. This could be achieved by multiplying the nominal values of the stock purchased throughout the year by an amount equal to the rate of inflation that has occurred between the date of purchase and the end of the accounting period. That is, the \$25,550 of stock purchased on 30 June 1980 would be adjusted for the effects of 3 quarters of inflation, the \$26,020 of stock purchased on the 30 September 1980 for the effects of 2 quarters of inflation, and the \$26,530.20 of stock for the effects of one quarter of inflation. These amounts could then be added to the nominal value of the stock purchased on 31 March 1981 to determine the indexed cost of closing stock as at 31 March 1981. These calculations are outlined below:

Indexed closing stock	=	\$25,500.00	x	1.06
		+ \$26,010.00	x	1.04
		+ \$26,530.20	x	1.02
	=	\$8,243.22		

Taxable income from trading stock for the year ending 31 March 1981 would then be calculated as follows:

	Sales revenue	\$105,101.00
plus	Indexed closing stock	\$108,243.22
less	Purchases	\$105,101.00
less	Opening stock	\$100,000.00
less	Inflation adjustment	\$8,243.22
	Taxable income	\$ 0

This approach of indexing closing stocks for the effects of inflation as well as allowing a deduction for the inflation rate multiplied by the average level of stock on hand can be referred to as the "indexed FIFO" methodology. The size of the closing stock adjustment depends on the frequency with which trading stock is turned over. The more frequently stocks are turned over, the smaller the closing stock adjustment. For instance, if all stock were turned over every quarter, the indexation of opening stocks alone would give the same result as the quarterly indexed FIFO approach.

### **Index the Average Stock Level**

As discussed above, the simplest but also least accurate method of calculating average stock on hand is by using opening stock. A second possibility is to take the average of opening and closing stock in order to gain a better estimate of the value of stock held over the year. This option was suggested by the McCaw Committee. This amount is then multiplied by the rate of inflation over the accounting year to determine the appropriate inflation adjustment.

The indexation adjustment would be calculated as follows:

$$\text{Inflation adjustment} = \frac{(A + B) \times (C-1)}{2}$$

where:

$$\begin{aligned} A &= \text{Opening stock} \\ B &= \text{Closing stock} \\ C &= \frac{\text{Index number for end of accounting year}}{\text{Index number for end of preceding accounting year}} \end{aligned}$$

In the case of the example under consideration:

$$\begin{aligned} \text{Inflation adjustment} &= \frac{(\$100,000 + \$105,101) \times 0.082}{2} \\ &= \$8,453.24 \end{aligned}$$

Assuming that trading stock is valued on either a replacement cost or indexed FIFO basis, assessable income from trading stock for the year ending 31 March 1981 would then be calculated as follows:

	Sales revenue	\$105,101.00
plus	Closing stock	\$108,243.22
less	Purchases	\$105,101.00
less	Opening stock	\$100,000.00
less	Inflation adjustment	\$8,453.24
	Taxable income	- \$210.02

This particular indexation methodology could be employed by most taxpayers, regardless of whether they calculate the value of their closing stocks on a cost, market value or replacement cost basis.

In order to gain a more accurate measure of the level of stocks held over the accounting year, an average could be taken of the value of stocks held at regular intervals throughout the year (e.g. quarterly, monthly, or even daily). This average stock level would then be adjusted for the effects of inflation over the accounting year by multiplying it by the inflation rate over the period. The inflation rate over the period is equivalent to the ratio of the index number for the quarter in which the accounting year ends to the index number for the quarter in which the previous accounting year ended, minus one. The resultant amount would constitute an inflation adjustment which would be deductible for tax purposes.



In the case of the example under consideration, taxable income under the average stock method would be calculated as follows (assuming stocks are valued on a replacement cost or indexed FIFO basis):

		Quarterly average of nominal stock
	Sales revenue	\$105,101.00
plus	Closing stock	\$108,243.22
less	Purchases	\$105,101.00
less	Opening stock	\$100,000.00
less	Inflation adjustment	\$8,347.29
	Taxable income	\$104.07

This indexation method would be appropriate only for taxpayers who are able to determine their stock levels throughout the year. As discussed in section 6.2, taxpayers tend to monitor the value of stock on hand throughout the accounting year at different frequencies. For example, many large businesses employ perpetual inventory control systems to keep constant track of the value of their stock on hand. However, there are many small businesses who may not have an accurate estimate of stock on hand throughout the year. This suggests that requiring indexation on a quarterly basis would impose excessive compliance costs on some taxpayers. Any requirement for taxpayers to report quarterly stock levels would have to be restricted to those taxpayers with average stock levels that exceed a specified value (e.g. \$1 million).

## LIFO

It is often argued that income from trading stocks could be adjusted for the effects of inflation by calculating the value of closing stocks on a "last-in, first-out" (LIFO) approach to inventory accounting. This approach is not currently accepted by the Inland Revenue Department.

Once again, this approach can be illustrated by considering its application to the above example. Under a LIFO approach, the units of stock on hand at the end of the accounting year are assumed to be the ones that were first acquired. That is, the 100,000 units of stock on hand as at 31 March 1981 are assumed to be the original 100,000 units that were acquired for \$1 each on 31 March 1980. As a result, as at 1 March 1981 the taxpayer is deemed to have sold all of the units of stock that have been purchased since 1 April 1980 and the 100,000 units that were purchased on 31 March 1980 are deemed to be on hand. The value of closing stock under a LIFO approach is therefore \$100,000.

Taxable income from trading stock for the year ending 31 March 1981 would be calculated as follows:

	Sales revenue	\$105,101.00
plus	Closing stock (LIFO)	\$100,000.00
less	Purchases	\$105,101.00
less	Opening Stock	\$100,000.00
	Taxable income	\$0

In this particular instance, the valuation of closing stocks on a LIFO basis would ensure that no inflationary gains in the value of trading stock were recognised for tax purposes. Once again, this result is due to the particular assumptions that have been made about the timing and quantities of stock purchased and sold throughout the year.

However, LIFO is an inaccurate method of adjusting the income produced by trading stock for the effects of inflation. Such a method would certainly reduce the taxable income from trading stock during periods of general price inflation. However, the benefits of LIFO are only obtained to the extent that stock levels are maintained indefinitely. Once stock levels are run down, the benefits of LIFO would decrease. In addition, LIFO would also reduce assessable income when the price of trading stock in question rises in relation to other assets. As discussed in Chapter 4, such an adjustment would tend to reduce economic efficiency by distorting the relative rates of return offered by different assets. For this reason, the calculation of the value of closing stocks on a LIFO basis is not considered to be an appropriate approach to adjusting the assessable income derived from trading stock.

## 6.4 Neutrality

Provided stock on hand at the end of the year is valued using up-to-date costings, any of the indexation procedures discussed above would substantially remove the effects of inflation for firms with stock levels which do not change much throughout a year. For firms with fluctuating levels of stock, the better the measure of average stock levels, the more accurately will be the inflation adjustment. More frequent determinations of trading stock levels are desirable where practicable to obtain as an accurate a measure as possible of average stock levels.

## 6.5 Administrative and Compliance Costs

Irrespective of the frequency with which stock levels are determined for the purpose of calculating the average stock level in a year, it is essential that trading stock is valued in end of year dollars if the adjustment for inflation is not to overcompensate for inflation. Some taxpayers such as those who value trading stock at market value, replacement or adjusted selling price already use values which are based in end of year dollars. For those who use a FIFO basis, it would be necessary to ensure that the price of stock on hand that is deemed to have been acquired in quarters which precede the final quarter of

an income year is grossed up to take account of inflation since the date of purchase. This would produce some increase in compliance costs but the information needed to conduct this adjustment is already available. In order to operate a FIFO system it is necessary for taxpayers to know the costs of items of stock and when this stock was acquired.

The compliance costs that would be encountered by taxpayers when calculating average stock levels for the purposes of the indexation provisions depend on the manner in which they currently account for this inventory and the frequency with which they are required to calculate stock levels.

Indexing the average of the opening and closing stocks appears to be a low-cost method of estimating average stock. Such an approach to indexation could be implemented by most taxpayers at little additional compliance cost.

It is also apparent that many taxpayers who already employ sophisticated inventory accounting systems are likely to be able to implement more accurate procedures for determining the average level of stock on hand without this substantially increasing their compliance costs. For such taxpayers, a more accurate measure of average stock levels could be obtained. For example, it would be feasible for many taxpayers currently employing sophisticated inventory accounting systems to compute the average level of trading stock on a quarterly, monthly or even daily basis.

This suggests that it may be appropriate to structure the indexation provisions for trading stock according to the level of sophistication of taxpayers inventory accounting systems. Small taxpayers who employ relatively unsophisticated inventory systems (e.g. those monitoring their stock levels only once a year) could be allowed to adjust the value of their opening stocks for inflation using the indexed average of opening and closing stock methodology. Those taxpayers employing more sophisticated accounting systems (e.g. those with average stock levels in excess of \$1 million) might be required to compute average stock levels on a quarterly basis. Such a "tiered" approach to the indexation of trading stock would ensure that the potential benefits of indexation are better matched to the associated compliance costs.

## **6.6 Conclusion**

In principle, it is possible to index individual units of certain types of trading stock in the manner outlined in Chapter 5 for assets that produce taxable profits on sale. In practice, however, the compliance costs associated with such an indexation methodology would be prohibitive.

The preferable approach is to treat trading stock as a single asset and to index the income produced by that asset for the effects of inflation. This would be achieved by estimating the average value of trading stock over the accounting period and requiring taxpayers to use a method of valuing trading stock which is based in dollars of the final quarter of an income year. A deductible inflation allowance would be provided to compensate taxpayers for the effect of inflation on the average value of the asset over the accounting year. A "tiered" approach to the estimation of the average value of trading stock would be adopted. Under this approach, the majority of taxpayers who currently employ relatively unsophisticated inventory systems would calculate the average value of their stocks on the basis of a simple average of the opening and closing stock. Those taxpayers who currently employ more sophisticated inventory control systems (e.g. those with average stock levels in excess of say \$1 million) would calculate the average value of their stock by calculating the average value of their quarterly stock levels expressed in end of year dollars. Such an approach would ensure that the potential benefits of indexation are better matched to the associated compliance costs.

# CHAPTER 7: INDEXATION OF DEPRECIABLE ASSETS

## 7.1 Introduction

Inflation increases the effective tax rates imposed on the real income produced by depreciable assets over their economic lives. It does this by eroding the real value of the depreciation deductions allowed for loss in the value of assets that cannot be made good by repairs and maintenance.

The erosion of the real value of depreciation allowances occurs because the two most common methods of calculating depreciation deductions (i.e. the cost price basis and the diminishing value basis) both provide depreciation allowances based on the historical cost of the asset. Allowable depreciation deductions are therefore expressed in historical dollars rather than in constant dollars of the periods in which depreciation deductions are claimed. The greater the cumulative inflation of the general price level that has occurred between the date that an asset was acquired and the date at which a given depreciation deduction is allowed, the lower will be the real value of that deduction to the taxpayer and, other things being equal, the larger will be the extent to which assessable income overstates real economic income.

In addition, the depreciation recovery provisions of section 117 of the Act operate to bring into assessable income, at the time of disposal of a depreciable asset, an amount equal to any excess of the consideration received on sale over the depreciated value of the asset, up to a maximum equal to the sum of the allowed depreciation deductions. The depreciated value of the asset and the sum of the allowed depreciation deductions are stated in the historical dollars of the date on which the asset was acquired. By contrast, the consideration received on sale of the asset is measured in terms of current dollars of the date of sale. It follows that, where the general price level has increased between the date of acquisition and the date of sale, the recapture provisions will often claw back depreciation deductions that have in any case understated the fall in the real value of a wasting asset. Thus, the overstatement of real income during the period that a depreciable asset is used by a taxpayer in the production of assessable income is compounded by a further overstatement of real income when the asset is sold.

This chapter describes the proposed method of indexing depreciation allowances for the effects of inflation and assesses the impact of this reform on the neutrality of the tax system and its implications for administrative and compliance costs.

## 7.2 The Objective of Indexation

Any assessable income generated by depreciable assets such as buildings, plant, machinery and equipment is currently recognised for tax purposes on an

annual basis. In the course of deriving that assessable income, taxpayers are allowed, at the Commissioner's discretion, to deduct an annual allowance for any loss in the value of the asset due to fair wear and tear which cannot be made good by repair. These annual depreciation allowances are based on the original cost of the asset and are intended to spread that cost over the useful life of the asset.

In all cases, the objective of indexing depreciation allowances is to preserve their real value in situations where the general price level has increased between the time that a depreciable asset is acquired and the dates on which the depreciation deductions in respect of that asset are allowed.

Depreciation indexation, in conjunction with an indexed balancing adjustment in the year of sale, is intended to ensure that the sum of the allowable depreciation deductions over the period that the asset is held, less any claw back at time of sale (all consistently measured in constant dollars of the time of sale), provides a workable approximation to the difference between the sale price of the asset and its acquisition cost converted to constant dollars at the time of sale.

Indexation is not designed to correct for any deficiencies in the timing of allowable depreciation deductions that might exist in the absence of inflation.

### **7.3 The Mechanics of Indexation**

The two most commonly employed methods of depreciation are the diminishing value basis and the cost price basis.

The diminishing value basis defines the depreciation allowance for a year as a fixed percentage (the depreciation rate) of the opening book value and makes the opening book value the previous year's opening book value less the depreciation allowance of that previous year.

The cost price basis defines the annual depreciation allowance as a fixed proportion of the original cost of the asset. The cost price, or straight line basis, thus spreads the depreciation allowance in equal amounts over an estimated asset life.

#### **Indexation of Diminishing Value Depreciation**

In order to provide inflation indexation for depreciation allowances taken on a diminishing value basis, it is proposed that the allowable depreciation in each year would be calculated prior to the indexation of the value of the asset for the annual change in the CPI.

Thus, the depreciation allowance for tax purposes in any year would be calculated as:

Indexed Opening Value x Depreciation Rate

In the year the asset is acquired, the indexed opening value would be its (unindexed) acquisition cost and allowable depreciation would be prorated according to the proportion of the year that the asset has been held.

In subsequent years, the indexed opening value would be the indexed closing value of the previous year.

The indexed closing value in any year would be calculated as:

(Indexed Opening Value - Depreciation Allowance) x Inflation Factor

In any full year for which the asset is held, the inflation factor would be the ratio of the CPI in the final quarter of the year to the CPI in the final quarter of the previous year. In the year of acquisition, the inflation factor would be the ratio of the CPI in the final quarter of that year to the CPI in the quarter that the asset was purchased.

As at present, no separate depreciation deduction would be provided in the year of sale. The indexed cost for the purposes of the balancing adjustment in the year of sale would be:

Indexed Opening Value x Inflation Factor

In the year of sale, the inflation factor would be the ratio of the CPI in the quarter that the asset is sold to the CPI in the final quarter of the previous year.

The effect of these rules would be that depreciation is not inflation adjusted in the year in which the asset is acquired.

It is proposed that the depreciation recovery provisions of section 117 would be amended so that the balancing adjustment in the year of sale of a depreciable asset is equal to the difference between the consideration realised on sale of the asset and its indexed cost.

The effect of section 117 would then be to make a balancing adjustment in the year of sale for any difference between the allowed real depreciation deductions (expressed in constant dollars at the date of sale) and the actual change in the real value of the asset over the period it has been held.

Section 117 limits the amount included in assessable income in respect of a depreciable asset to the sum of the previously allowed depreciation deductions. Consistent with the removal of capital income exemptions, it is proposed that this limitation would be removed in an indexed tax system. When depreciation is indexed, the depreciation recovery limitation would, in any case, only come into operation in cases where real depreciation has been allowed in respect of an asset which has in fact appreciated in real value between the time of acquisition and the time of sale. In such (presumably rare) instances, the tax treatment received by the asset would in any case have been very concessional relative to other assets which show a real gain at time of sale.

With these amendments to section 117, the indexed book value of a depreciable asset would play the same role in the calculation of the realised real gain or loss on sale as the indexed cost would for non-depreciable assets.

### **Example**

Consider the case of a firm that purchases an asset for \$1,000 at the end of the second quarter of its financial year, holds the asset through the next year and sells it for \$880 at the end of the third quarter of the third year. Assume that the allowed depreciation rate is 20%, that the annual inflation rate is 10% and that the CPI in the final quarter of the financial year prior to that in which the asset was purchased is 100. The CPI will then be 105 in the quarter of acquisition, 110 at the end of the first year, 121 at the end of the second year and 130 in the quarter of sale.

#### **First Year**

Acquisition Cost: \$1000

Depreciation Allowance:  $\$1000 \times 0.2 \times 0.5 = \$100$

Memo Item: Historical Cost Depreciation = \$100

Indexed Closing Value:  $(\$1000 - \$100) \times 110/105 = \$943$

Memo Item: Historical Cost Closing Value = \$900

#### **Second Year**

Indexed Opening Value: \$943

Depreciation Allowance:  $\$943 \times 0.2 = \$189$

Memo Item: Historical Cost Depreciation = \$180

Indexed Closing Value:  $(\$943 - \$189) \times 121/110 = \$829$

Memo Item: Historical Cost Closing Value = \$720



### **Third Year**

Indexed Opening Value: \$829

Indexed Cost:  $\$829 \times 130/121 = \$891$

Balancing Adjustment:  $\$891 - \$880 = \$11$  (deductible)

Memo Item: Existing Balancing Adjustment:  
 $(\$880 - \$720) = \$160$  (assessable)

Comparison of the indexed depreciation allowances and the existing historical cost depreciation allowances (recorded above as a memo item) illustrates the manner in which depreciation allowances under the existing historical cost system systematically understate indexed depreciation. Since the understatement rises with accumulated inflation, this difference would become more marked if the years for which the asset were held were increased beyond those of this example. The large difference in the taxpayer's position in the year of sale (a deductible balancing adjustment of \$11 under indexed depreciation as against \$160 of assessable income under the existing historical cost system) illustrates the manner in which the historical cost system claws back the already inadequate depreciation allowances provided in earlier years.

### **Indexation of Cost Price Basis Depreciation**

Where depreciation allowances are taken on a cost price (i.e. straight line) basis, it is proposed that the method outlined above would again apply, with the sole difference that the depreciation allowed in any year would be the indexed opening value (or unindexed acquisition cost in the initial year) spread equally over the remaining life of the asset and prorated over the portion of the year for which the asset is held.

## **7.4 Neutrality**

Table 7.1 demonstrates the impact that the interaction of the existing historical cost depreciation rules and inflation can have on the effective tax rates imposed on the real income from a depreciable asset. The assumptions employed for the purposes of the analysis are the same as those in Annex 3.4. In particular, it is assumed that the real pre-tax rate of return is 10% per annum, that tax depreciation rates equal true economic depreciation rates in the absence of inflation and that the statutory tax rate is 33%. It is assumed that the income produced by the asset is realised at end of the accounting year and that the real residual value of the asset at the end of its economic life is 10% of its initial cost.

**Table 7.1**  
**Effective Tax Rates on Real**  
**Income: Historical Cost Depreciation**

Economic Life (years)	Inflation Rate		
	2%	5%	10%
5	39	47	59
10	38	45	54
15	38	44	51
20	37	42	48
25	37	41	46
30	36	40	44
35	36	40	43
40	36	39	42

As the table illustrates, historical cost depreciation raises effective tax rates on real economic income under conditions of inflation. To the extent that allowable depreciation rates provide an appropriate approximation to the rate of decline in the real value of depreciable assets, indexation of depreciation allowances, together with indexation of the balancing adjustment on sale, will prevent the cumulative effects of inflation from raising effective tax rates on real economic income above the statutory tax rate.

## 7.5 Administrative and Compliance Costs

The administrative and compliance costs associated with fully indexing depreciable assets for inflation would seem to be very small. The only additional step involved in deriving indexed depreciation allowances is the calculation of the indexed closing value in any year.

Issues raised by the transition to an indexed depreciation system are discussed in Chapter 17.

## 7.6 Conclusion

Under the existing provisions of the Income Tax Act, deductions can be allowed by way of depreciation for any loss in the value of assets that cannot be made good by repairs and maintenance. However, since these allowances are calculated on the basis of the original cost of the asset they are expressed in historical dollars rather than in constant dollars at the dates on which

depreciation deductions are claimed.

As a consequence, the real value of depreciation allowances is eroded by the cumulative effects of inflation between the time an asset is acquired and the dates on which depreciation is deductible. The compliance costs of indexing both depreciation allowances and the balancing adjustment on sale appear very small relative to the distortions of effective tax rates on real economic income that can thereby be avoided in times of inflation.



# CHAPTER 8: INDEXATION OF FINANCIAL ARRANGEMENTS AND DEBT INSTRUMENTS

## 8.1 Introduction

During periods of inflation, the existing income tax system by taxing nominal interest income tends to over-tax investors in financial assets and under-tax business borrowers by allowing deductions for nominal rather than real interest expense.

This Chapter examines how financial arrangements could be indexed so that the inflationary component of interest is neither assessable nor deductible.

The existing tax treatment of financial arrangements is mainly governed by the accrual rules in sections 64B-64M of the Act. This Chapter refers to income derived in respect of a debt instrument or a financial arrangement as interest income. Expenditure incurred in respect of financial arrangements is referred to as interest expense. Thus, the generic term interest income includes amounts (such as income derived from a debt forgiveness) that constitute income derived under the accrual rules.

The accrual rules refer to "issuers" and "holders" of financial arrangements. In most cases, holders of financial arrangements are lenders and issuers are borrowers. For simplicity, the terms "borrowers" and "lenders" will be used to denote issuers and holders of financial arrangements respectively.

The indexation of financial arrangement income is the most difficult element of indexation because of the variety of financial instruments and different levels of sophistication of taxpayers. This Chapter discusses how the more common financial instruments might be indexed. Indexation applied to such arrangements illustrates the main principles of the indexation procedure for all financial arrangements.

The chapter focuses on three types of instrument:

- accounts with banks and other financial institutions, where the amount of principal in the accounts may be varied as taxpayers contribute or withdraw funds. These are described as variable principal instruments;
- term deposits paying a fixed-rate of interest. These are "fixed-rate instruments" but are not tradeable and cannot be transferred between taxpayers. When a deposit is withdrawn, it is in practice generally unnecessary to compute any base price adjustment if the interest income has been returned over the term of the deposit, assuming that the amount withdrawn is usually equal to the cost of the asset. Such

instruments are described as non-transferable fixed-rate instruments;  
and

- tradeable instruments bearing a fixed rate of interest such as government stock, commercial bills, fixed-rate debentures and certificates of deposit.

The reforms outlined preserve the current distinction between accrual and cash basis taxpayers, as defined in section 64C of the Income Tax Act. In brief, a lender is taxed on a cash basis if he or she is a natural person and earns less than \$50,000 by way of income on financial arrangements or holds arrangements which do not exceed \$400,000 in value and, in either case, would have no more than \$15,000 of additional assessable income if income were taxed on an accrual basis rather than a cash basis. Such taxpayers are subject to tax on interest when it is received and can also deduct interest expenses on an incurred basis if they owe less than a threshold level under financial arrangements. Other taxpayers are required to compute income and expenditure on an accrual basis.

## 8.2 General Principles

Several general principles underlie the discussion in this chapter. First, the method of indexing interest income/expense should be consistent with the overall objective of indexation noted in Chapter 4. A fall in the real value of any monetary asset should be offset against nominal income from that asset at the time that income is recognised for tax purposes. If interest income is taxed as it accrues the inflation adjustment should be made on an accrual basis. If income is not recognised until a financial arrangement is realised or interest is received, the adjustment for the inflation component of such amounts should occur then.

Second, except where compliance or tax avoidance concerns require otherwise, indexation should replicate as closely as possible the tax system which would operate in an inflation-free world. In the absence of inflation, if a taxpayer were to lend money at a positive interest rate, the interest would be assessable. An individual may lend to a financial institution at a negative interest rate (i.e., an interest rate less than the rate of inflation) because of the services that the financial institution provides. Under general income tax principles, if these services (such as account facilities) provide a private benefit, the taxpayer should not be able to deduct the cost of obtaining the services. In the same way, under an indexed income tax system, an individual who lends at a positive real interest rate should be taxed on the real income he or she derives but a taxpayer who lends at a negative real interest rate because he or she receives untaxed services should not receive a deduction.

If payments for private services by way of negative real interest rates were deductible there would be a greater bias in favour of the provision of services and against the payment of interest than would exist in a non-inflationary world.

Potential tax avoidance opportunities would make it desirable to deny a deduction for any negative real interest rate loan irrespective of whether or not the negative interest rate is a payment for what amounts to consumption benefits. The sorts of avoidance possibilities if negative real interest were deductible to lenders are outlined in Chapter 9.

Nevertheless, a lender may expect a positive return from a financial instrument but may instead receive only a negative real return. This may be caused by a loan going bad, by changes in interest rates or because of unanticipated exchange rate movements if the instrument is denominated in a foreign currency. If losses caused by such events were made non-deductible, this would penalise loans to riskier borrowers. Therefore, where the holder of a financial instrument makes a real loss, the loss should be deductible if the instrument could reasonably have been expected to yield a positive real interest rate at the time it was acquired.

Finally, it should be noted in passing that an inflationary gain earned by borrowers in respect of interest that is non-deductible for tax purposes (e.g., interest paid on home mortgages) would not be assessable.

### 8.3 Basic Approach to Indexation

To illustrate the impact of inflation on taxable income, assume that at the beginning of year 1 taxpayer X deposits \$10,000 in a bank. The loan pays \$1,000 of interest at the end of year 1. If the inflation rate over the year was 6%, X would need \$10,600 at the end of the year to maintain the real value of his or her capital. Thus, \$400 of the \$1,000 of nominal interest is real interest income. The other \$600 may be described as a "lending loss". Conversely, when the bank pays interest of \$1,000, only \$400 of this is real expenditure. The other \$600 may be described as a "borrowing gain".

In this simple example, both a cash basis and an accrual basis holder should pay tax on \$400 in year 1. For both types of taxpayer the indexed income would be calculated as follows:

$$a - (b \times p)$$

where:

a is the amount of nominal interest income or expense computed as at present;

b is the balance in the account throughout year 1. As discussed below, where the balance in an account changes throughout a year, b would be the average balance in the account; and

p is the rate of inflation for the year.

That is, income for the depositor would be computed as  $\$1,000 - (\$10,000 \times 0.06)$  which equals \$400. Deductible expenditure for the bank should be calculated on a similar basis.

## 8.4 Neutrality

Table 8.1 below illustrates the results of applying the above method of indexation on the effective tax rates on real income under different inflation assumptions. The results in the table assume that a 5-year bond is acquired at the end of an income year and yields real pre-tax interest of 10% per year payable annually in arrears. The statutory tax rate is assumed to be 33% and the rate of inflation is assumed to be constant over the term of the bond.

**Table 8.1**  
**Effective Tax Rates on Real Income**  
**Derived From Five-year Bond**

	%	%	%
Inflation rate	2	5	10
Nominal Pre-tax Yield	12.2	15.5	21
Effective Tax Rate (No indexation)	39.5	48.7	63
Effective Tax Rate (Indexation Adjustment)	33	33	33

As can be seen from the table, the effective tax rate on real interest income rises sharply with the rate of inflation in an unindexed tax system. In contrast, the indexation of principal outstanding results in an effective tax rate that is equal to the statutory rate regardless of the rate of inflation. As illustrated by the examples set out in Annex 8.1, these conclusions also apply to other types of financial instrument such as those with different terms or issue prices.

## 8.5 Mechanics of Indexation

As noted above, the discussion in this chapter focuses on three types of debt instrument - variable principal instruments, non-transferable term deposits and transferable fixed-rate instruments such as government stock. The mechanics of indexing each of these three types of instrument are discussed



below. In discussing some of the detailed mechanics of indexation, details such as the mechanics of prorating indexation adjustments across time are ignored for the purposes of exposition.

### 8.5.1 Variable Principal Instruments

The main type of variable principal instrument held by most taxpayers is ordinary cheque and savings accounts. The amount of principal would tend to vary frequently in accordance with the pattern of deposits and withdrawals. Interest paid on such accounts is typically computed on the basis of average or minimum daily balances over a certain period (e.g. monthly or quarterly) and is generally paid at regular intervals.

#### Cash Basis Holders

The most accurate way of ensuring that cash basis holders exclude, in full, the inflationary component of interest would be to compute the indexation adjustment by reference to the average daily balance of such an account over the period to which the payment of interest relates.

Suppose, for example, that a bank savings account pays interest in arrears on 31 December 1991 and 30 June 1992 based on the average daily balance in the account for the immediately preceding six month period. The indexation adjustment would be computed in respect of each of the six monthly periods to which the interest payments relate. The indexation adjustment in respect of the 31 December 1991 interest payment would be computed as follows:

- the average daily balance of principal outstanding over the period to which the interest relates (i.e., the 6 months to 31 December) would be computed. Interest in respect of savings accounts would normally be computed on the average or minimum daily balance over a period (e.g., quarterly). Both approaches would mean that the borrower (i.e., the bank) would need to know the daily balance of principal outstanding in the account. Thus, the average daily balance could be computed with little if any modifications to existing systems to compute interest income/expense. In practice also, the minimum daily balance could be used;
- the inflation rate for the period would be expressed as a decimal. This could be computed by dividing the index number applicable to the final quarter of the period (i.e., the December quarter 1991) by the index number for the final quarter of the previous six month period (i.e., the June quarter 1991) and subtracting 1. For example, if the result of dividing the two index numbers was 1.043, the inflation rate for the six months expressed as a decimal would be 0.043 - an inflation rate of 4.3%; and

- the inflation rate of the period would be multiplied by the average daily principal outstanding for the period to compute the indexation adjustment. The cash basis holder would exclude the indexation adjustment from interest declared in his or her income tax return for the year.

In many instances, financial institutions may compute the amount of interest to be excluded from assessable income as a service for their customers. If, however, an institution were to fail to provide this information, lenders could compute the inflation adjustment on the basis of the minimum daily balance over any period to which a payment/s of interest relate. For example, the minimum daily balance of an interest bearing deposit may be \$100 during a year. The amount excluded from interest income would be computed by multiplying the minimum balance of \$100 by the inflation rate during the year. While this would result in a lower indexation adjustment for the lenders, it might be a good approximation if the compliance costs of full indexation are high relative to the difference between full and partial indexation.

If interest periods are relatively short and interest is paid frequently, an institution could compute an indexation adjustment either in relation to each interest payment or could undertake the adjustment in respect of all interest payments to the holder over a year. In the latter case, the average of minimum daily balances would be computed over the span of all interest periods in relation to which interest was paid during the year. For example, if interest is paid monthly, an institution could compute the indexation adjustment in respect of total interest paid over the twelve months. The adjustment would be the average or minimum daily balance over the twelve months multiplied by the inflation rate from the first to the last month inclusive. The institution would advise the customer after the end of the year of the total amount of nominal interest paid over the year and the amount that should be excluded from assessable income.

Cash basis holders could also be provided with the relatively low-cost option of excluding a standard fixed proportion of the interest income they receive from an account in any year. This will be called the "fractional exclusion" method. Under this approach, the Inland Revenue Department would publish each year a standard fraction of interest income that cash basis holders could exclude from their assessable income. This fraction would be the inflation rate for the year divided by an estimated yield on ordinary savings accounts.

Since interest yields on deposits may vary, the standard fraction published would, at best, be an approximation of the true proportion of interest that merely compensates for inflation. To ensure that this fractional exclusion method does not significantly understate real interest for most taxpayers, it is likely that the published rate would be based on deposits that yield relatively high interest. This would mean that it would generally produce slightly higher taxable income but with low compliance costs.

## **Accrual Basis Taxpayers**

Accrual basis taxpayers are currently required to accrue interest income/expense on a yield-to-maturity or equivalent basis each year. These taxpayers should be entitled to accrue lending losses or borrowing gains on debt instruments on the basis of their:

- average daily balance of such instruments during a year, multiplied by the inflation rate for the year; or
- in the case of issuers of such instruments (i.e. taxpayers who derive borrowing gains), the maximum daily balance of such instruments during a year, multiplied by the inflation rate for the year; or
- in the case of holders of such instruments (i.e., taxpayers who incur lending losses), the minimum daily balance of such instruments during a year multiplied by the inflation rate for the year .

If taxpayers use minimum or maximum balances they could choose to compute indexation adjustments more than once a year to increase the accuracy of the indexation adjustment. For example, they may choose to compute the minimum or maximum balance for each quarter and multiply the balance by the inflation rate for the quarter. The sum of the indexation adjustments computed for each of the four quarters would be the amount excluded from interest income/expense.

Inflation rates may vary during the course of a year. If it were considered desirable to derive a more accurate measure of the amount to be excluded from nominal interest, average daily balances could be measured each quarter and multiplied by the inflation rate for the quarter. Annual lending losses/borrowing gains would be the sum of indexation adjustments computed for each quarter.

### **8.5.2 Non-Transferable Fixed-Rate Instruments**

These instruments offer a fixed interest rate and are generally not tradeable. A typical example would be a term deposit. When a deposit is withdrawn, it is, in practice, generally unnecessary to compute any base price adjustment, assuming the deposit holder has returned interest over the term of the deposit, because the amount or amounts finally withdrawn are usually equal to previously accrued interest and the amount deposited.

### **Cash Basis holders**

For cash basis holders, these instruments would be treated in the same way as variable principal instruments. The amount excluded from interest income would be computed by reference to either of the two options outlined for cash basis holders of variable principal instruments.

The most satisfactory method for determining the fractional exclusion factor in the fractional exclusion method would be for the Inland Revenue Department to publish a suitable factor for each of a limited number of categories of fixed-rate financial arrangements each year. For example, a fractional exclusion rate could be set for instruments at call (as discussed previously in relation to variable principal instruments) deposits of less than 180 days, deposits with term of between 180 and 360 days, those with a term between one and two years and more than two years.

The greater the number of different categories and fractional exclusion rates, however, the higher the compliance costs faced by taxpayers.

### **Accrual-Basis Taxpayers**

Taxpayers required to accrue interest income/expense must do so on a yield-to-maturity (or other) basis provided for under the accrual rules. Interest income can be accrued in most cases by multiplying the principal outstanding at the beginning of each period in relation to which interest is payable by the true interest rate applicable to that period. Where the period is less than a year, the interest computed is prorated on a daily basis to reflect interest accrued during that period.

Exactly the same calculation would be applied to compute the indexation adjustment, with the only difference being that the inflation rate would be substituted for the true interest rate. If interest were accrued in any year on the basis of an annual interest rate, the indexation adjustment would be made using the annual inflation rate for the income year.

The calculation of the indexation adjustment outlined in the previous paragraph is equivalent, in effect, to the result obtained when the average daily balance of the instrument for any period is multiplied by the inflation rate for the period.

Consider the application of the approach outlined above to the indexation adjustment of interest expense. Suppose, for example, that an accrual basis taxpayer with a 31 March balance date issues an instrument on 15 October for \$1,000. Interest is payable on the instrument at 12% per annum. Suppose also that inflation in the taxpayer's year of issue is 4%. Currently, the taxpayer would accrue the nominal interest expense for the period to 31 March first by multiplying the amount of principal outstanding on 15 October (i.e., \$1,000) by the annual interest rate of 12%. Secondly, that interest of \$120 would be prorated on a daily basis to accrue the correct amount of interest expense for the year.

The amount to be excluded from nominal interest expense would be computed in a similar way. The \$1,000 of principal outstanding on 15 October would be

multiplied by the relevant annual inflation rate and prorated on the same daily basis as interest income to match the taxpayer's income year. Interest expense taken into account for tax purposes would be nominal interest accrued less the indexation adjustment.

### 8.5.3 Transferable Fixed-Rate Instruments

Transferable fixed-rate instruments include government stock, commercial bills, fixed-rate debentures and certificates of deposit.

The amount paid on maturity or sale of such an instrument is not necessarily equal to its cost. Hence, as is the case under the present accrual rules, base-price or cash base price adjustment will be required to correct any previous over- or under-accrual of interest.

#### Cash Basis Holders

The indexation adjustment for cash basis holders would, in general, be computed each year in a similar way to the indexation of other instruments. That is, the amount of indexation adjustment in any year would be either:

- the adjusted principal at the end of the preceding year multiplied by the annual inflation rate for the year. The adjusted principal of the asset at the end of any year would be its cost, if acquired during the year, or its adjusted principal at the end of the previous year, less any principal repayment plus any additions to principal during the period; or
- interest received multiplied by the standard exclusion factor applicable to the instrument for that year.

Under either of the above approaches, cash basis holders would be required to compute the cash price adjustment when the instrument matures or is sold. The cash price adjustment would be computed in constant dollars at the time the instrument is sold or matures. In effect, the cash price adjustment in the year an instrument is sold or matures would be its sale price minus its adjusted principal at the end of the preceding income year grossed up by inflation between that time and the time of disposal. The adjusted principal indexed for inflation is referred to as "indexed adjusted principal".

The indexed adjusted principal of an instrument at the end of any income year would be:

$$a - b - c$$

where:

- a is the adjusted principal of the asset at the end of the previous year (or its acquisition price if acquired during the year), grossed up by the inflation rate since the beginning of the year or the acquisition date;
- b is any principal repayments over the year, grossed up by the inflation between the time the payments were made and the end of the income year; and
- c is the amount of nominal interest excluded from taxable income as an inflation adjustment in respect of the year under either of the two approaches outlined above.

A negative cash price adjustment in the year the instrument matures or is sold would not be deductible unless, as noted in section 8.2, the arrangement was entered into on arm's length terms and could reasonably have been expected to yield positive real interest at that time.

The approach outlined in the previous paragraphs is illustrated by an example in Annex 8.2.

### **Accrual Basis Taxpayers**

Accrual basis taxpayers would compute the indexation adjustment for transferable fixed-rate instruments in the same way as for non-transferable fixed-rate instruments except that they would use yield-to-maturity or an equivalent method to compute accrued interest income and the indexation adjustment.

These taxpayers would compute a base price adjustment when the instruments are sold or mature to ensure that income and expenditure that is not taken into account during the term of an arrangement is accounted for at that time.

The formula for calculating income or expenditure under the base price adjustment is set out in section 64F(2) of the Act. The base price formula is given as  $a - (b + c)$  which is equivalent to  $a - b - c$ . Leaving aside the treatment of amounts remitted under a financial arrangement for simplicity, the terms of the formula for holders of arrangements are broadly as follows:

- a is all positive amounts received by the holder under the financial arrangement. These are all receipts received over the life of the instrument, being all coupon or interest payments plus principal payments;
- b is the acquisition price the holder acquired the financial arrangement for; and

- c is all amounts that are income derived under any provision of the Act, less the aggregate of amounts of expenditure incurred under yield-to-maturity rules.

To compute the real income in the year a financial arrangement is realised, each of the amounts taken into account in the expressions a, b and c of the base price adjustment formula would be adjusted for inflation so that they represented constant dollar values at the time of realisation. For example, interest receipts received over the life of an arrangement, the acquisition cost of the arrangement and net income previously subject to tax in respect of the arrangement would each be inflated by using the appropriate indexation factors.

As noted in the introduction to this section, the base price adjustment would be simplified where taxpayers periodically update the components of the base price adjustment for inflation.

The operation of the base price adjustment assuming the inflation indexation of all amounts to constant dollars at the time the arrangement matures or is sold is illustrated in Annex 8.3.

The definition of the expressions a, b, and c in the base price adjustment outlined in the formula above differ slightly in relation to issuers of financial arrangements. However, apart from this difference, issuers would inflation index amounts included in the base price adjustment in the same way as holders of financial arrangements.

#### **8.5.4 Instruments Not Subject to the Accrual Rules**

The following instruments are not subject to the accrual rules:

- debt instruments and financial arrangements held by non-residents;
- any financial arrangement which a particular taxpayer acquired or issued before the implementation date of the accrual regime ("pre-implementation date" financial arrangements); and
- excepted financial arrangements. These are arrangements specifically excluded from the accrual rules. Broadly, excepted financial arrangements include shares; annuities and contracts of insurance; bets, lottery winnings; short-term trade credits; hire purchase agreements; short-term and private or domestic agreements for the sale and purchase of property; options to acquire or sell property, other than an interest in a financial arrangement; and leases.

The application of indexation to each of the above categories of financial arrangements and debt instruments is considered in turn below.

## **Indexation of Interest Income Received by Non-residents**

Practical constraints and the need to integrate the New Zealand tax system with the tax systems of other countries mean that interest income derived by non-residents with no physical presence in New Zealand is generally subject to a final withholding tax, rather than to tax on net income as normally calculated.

As noted in Chapter 16, New Zealand's income tax system is integrated with the tax systems of other countries by way of double tax treaties. Under such agreements, countries with which New Zealand has a double tax treaty agree to credit against the tax liability of residents of that country any withholding tax levied by New Zealand on outgoing interest. Countries with which New Zealand does not have a double tax treaty may also often provide for credits for foreign withholding taxes.

The rates of tax levied by New Zealand on interest income derived by non-residents who have no physical presence in New Zealand differs from the rates that apply to such income in the hands of residents. This is due to two factors. First, the income is only taxed when it is paid to non-residents. This means that non-residents can defer the recognition of interest income and thereby reduce the effective tax rate on the income. Secondly, the statutory rate of tax is 15% (reduced to 10% in most double tax treaties). To the extent that any reduction in non-resident withholding tax levied on interest received by non-residents does not reduce the net tax liability of non-residents in their home countries, there is no advantage to New Zealand in indexing interest received by non-residents.

In view of the above considerations, there appears to be no strong reason for indexing interest received by non-residents for non-resident withholding tax purposes.

## **Pre-implementation Date Financial Arrangements**

Taxpayers holding or issuing pre-implementation date financial arrangements could either index the cost of such instruments or exclude a standard fraction of interest in the same way as cash basis holders could index fixed-rate instruments. With only minor modifications, such rules could also apply to issuers who are not required to accrue financial arrangement expenditure under the de minimis provisions.

The most significant modification to the rules that apply to cash basis holders would be in relation to issuers of pre-implementation date financial arrangements. If issuers decide to compute an indexation adjustment by reference to the daily balance or principal outstanding of an instrument, either the average or the maximum balance should be used.



## **Shares**

Excepted financial arrangements in the form of shares or options to acquire or sell shares would be subject to the rules for indexing equity instruments. These were outlined in Chapters 5 and 6.

## **Contracts of Insurance and Membership of a Superannuation Scheme**

The Act provides that distributions received in respect of interests in registered superannuation schemes are non-assessable. Proceeds from life insurance contracts and annuities issued in the course of a business carried on in New Zealand are also non-assessable. No indexation adjustment would therefore be required.

## **Short-term Trade Credits, Short-term or Private Agreements for the Sale and Purchase of Property**

The interest component of short-term trade credits and short-term or private or domestic agreements for the sale and purchase of property is often implicit in the price of the assets transferred pursuant to such arrangements. In view of the compliance costs of isolating the interest component of these transactions and accruing interest expense/income, they were excluded from the accrual rules. Compliance cost considerations also suggest that such arrangements should be excluded from any indexation adjustments.

## **Hire Purchase Agreements**

As discussed in Chapter 15, it would be desirable to change the treatment of hire purchase agreements in respect of assets other than trading stock. Hire-purchase agreements in respect of such assets would be treated as two separate transactions. First, the underlying asset would be deemed to be sold for its market value. Second, the vendor would be deemed to lend the purchaser the difference between the deemed purchase price and the initial payment on the contract.

Interest on the loan element of a hire purchase agreement would then be subject to indexation. The loan element could be treated as a fixed-rate instrument for indexation purposes.

## **Leases**

Rental payments that are adjusted annually represent a return to the owner of the asset (the lessor) in much the same way that interest represents a return to the holder of a financial arrangement. Likewise, a lessor can index the cost of an asset he or she leases in a similar way that the holder of a financial

arrangement could index the principal outstanding if financial arrangements were subject to indexation. Since lessors would be entitled to index the cost of the assets they own, rental income should not be subject to indexation.

From the perspective of lessees, annual rental payments represent a payment in current dollars for the services provided by the asset leased. Hence, it would be inappropriate to exclude a proportion of such payments from deductible expenditure. Such payments should not be subject to an indexation adjustment.

An exception to this general approach would be the transfer of an asset under arrangements that are akin to specified leases. These arrangements are described in Chapter 15. In general terms, the lessor under such an arrangement is deemed to have sold the asset to the lessee and loaned the lessee an amount equal to the deemed sale price of the asset. With indexation, the interest income/expense in respect of the loan portion would then be indexed. The loan portion of the lease agreement would be treated in the same way as any other transferable fixed-rate instrument.

## **8.6 Other Issues**

The above discussion focuses on a representative selection of monetary instruments and illustrates appropriate methods of inflation adjustment. These will be further developed in the light of submissions by interested parties. In particular, consideration will be given to the integration of indexation of financial arrangements with the current provisions of the Income Tax Act, such as the definition of dividends and resident withholding tax.

## **8.7 Conclusion**

The indexation of the principal outstanding under a debt instrument aligns the effective tax rate on real interest income with the statutory rate, regardless of the rate of inflation.

The mechanics of indexation of debt instruments is considered above in relation to three types of instrument - variable principal instruments, non-transferable fixed-rate instruments and tradeable fixed-rate instruments. The reforms outlined also preserve the current distinction between accrual and cash basis taxpayers. Interest should be adjusted for inflation at the time the interest is recognised for tax purposes.

Negative real interest should not be deductible, except where a taxpayer can establish that the instrument offered a normal arm's length commercial yield when acquired and could reasonably have been expected to yield a positive real interest rate at that time.

Broadly, cash basis holders could compute the amount of nominal interest to be excluded from assessable income either by:

- multiplying the minimum or average balance (or principal) of such instruments during the period to which interest payments relate by the inflation rate for the period; or
- multiplying their nominal interest receipts by a published standard fraction. The standard fraction would be an estimate of the inflationary component of the yield on an average instrument.

In many instances, financial institutions may compute the indexation adjustment on the basis of average or minimum daily balances as a service for their customers.

Accrual basis holders or issuers of variable-principal instruments could accrue amounts to be excluded from nominal interest income/expense in relation to any income year by multiplying the inflation rate for the year by:

- the average daily balance of such instruments during the year;
- the minimum daily balance during the year, in respect of instruments they hold; or
- the maximum daily balance during the year, in respect of instruments they have issued.

With regard to a fixed-rate instrument, accrual basis taxpayers would compute the indexation adjustment based on the yield-to-maturity of the instruments multiplied by the adjusted principal for the period to which the yield-to-maturity is computed.

The calculation of the base or cash price adjustment under the accrual rules is particularly important in relation to tradeable fixed-rate instruments. These adjustments would be computed in constant dollars of the time an instrument is sold or matures.

Taxpayers who hold or have issued pre-implementation date financial arrangements could compute the indexation adjustment on the same basis as fixed-rate instruments held by cash basis holders.

Excepted financial arrangements in the form of shares would be subject to the rules outlined in Chapters 5 and 6 in relation to equity instruments. Other excepted financial arrangements, such as insurance contracts, would not be subject to indexation adjustments because proceeds in respect of such instruments are non-assessable. Compliance cost considerations suggest that short-term trade credits should not be subject to indexation.

While the indexation of financial assets appears to be feasible in respect of most financial arrangements, the extent of the additional compliance and administrative costs indexation would impose should be the subject of consultation.

It would not be desirable to index income and expenditure in respect of some financial arrangements and debt instruments held by residents (such as those for which compliance costs are lowest) and not to index others. Given the close substitutability of different types of financial arrangements and their fungibility, the indexation of only some instruments could distort financial markets and open up obvious avenues of abuse. It is therefore necessary to determine appropriate methods for indexing all financial arrangements and other debt instruments that would result in the lowest overall increase in compliance costs.

The indexation of interest income and expenditure therefore presents the most difficult challenge in indexing the tax base. However, the discussion above of the various indexation methods suggests that indexing interest income and expenditure without imposing excessive compliance and administrative costs is feasible. However, the various methods of indexation outlined in this Chapter need further development in the light of submissions by interested parties. If the process of consultation confirms the feasibility of indexing interest income and expenditure, the indexation of financial arrangements could be undertaken in conjunction with, or soon after, the indexation of the rest of the income tax base.

## ANNEX 8.1

### Examples of Effective Tax Rates Under Different Inflation Assumptions

Assume that the rate of inflation is constant at 10% per annum and that 5 year Government stock is issued with a coupon of 14% at a price of 90% of its face value. Coupon interest is payable twice yearly. The resulting effective tax rates are shown in Table 8.1.1. The annual nominal pre-tax yield is 17.8% and the annual real pre-tax yield is 7.1%. Table 8.1.1 below shows the effective tax rates that result from indexing the arrangement under these assumptions.

**Table 8.1.1**  
**Effective Tax Rates on Real Income**  
**Derived From 5 Year Government Stock**  
**(Inflation rate = 10 % per annum)**

	%
No indexation	77
Indexation	33

Thus, there is virtually no change in the effective tax rates under the indexed system, though the rate under the unindexed system rises sharply.

Now assume that the rate of inflation is 2% per annum, that the stock carries a coupon of 7% and is issued at a price of 95% of its face value. The nominal pre-tax yield to maturity is then 8.4% per annum, while the real pre-tax yield is 6.3%. Table 8.1.2 gives the effective tax rates on real income in this case.

**Table 8.1.2**  
**Effective Tax Rates on Real Income**  
**Derived From Government Stock**  
**(Inflation rate = 2% per annum)**

	%
No indexation	44
Indexation	33

Once again, there is no change in the effective tax rates under the indexed tax system.

Finally, consider the case of a long-term zero coupon bond that is acquired for \$350 and is redeemed after 10 years for \$1,000. The annual rate of inflation over each of the ten years the bond is held is a steady 5% per year. The annual nominal pre-tax yield is 11.1% and the annual real pre-tax yield is 5.8%. Table 8.1.3 below shows the effective tax rates that result from applying indexation under these assumptions.

**Table 8.1.3**  
**Effective Tax Rates on Real Income**  
**Derived From a 10 Year Zero Coupon Bond**  
**(Inflation rate = 5% per annum)**

	%
No indexation	61
Indexation	33

## ANNEX 8.2

### Example of the cash price adjustment for a cash basis holder holding a transferable fixed-rate instrument

Suppose a cash basis holder acquires a bond for \$900 on the last day of his or her income year (year 0). Assume that the bond has a face value of \$1,000 and pays 5% interest per annum in arrears. Assume that the taxpayer holds the bond for two and a half years and sells it in the middle of year 3 for \$1,050. The inflation rate in year 1 is assumed to be 4%, in year 2 to be 7% and in the six months to the middle of year 3 to be 4%. The taxpayer would compute his or her income in respect of the arrangement in each year as follows:

	<u>Year 1</u>	<u>Year 2</u>
	\$	
Adjusted principal at beginning of year	900	900 (2)
Nominal Interest Income	50	50
<b>less</b>		
Indexation adjustment	36 (1)	63 (3)
<b>Equals</b>		
Assessable income (minimum value = 0)	14	0 (4)

#### Notes

- (1) i.e.,  $\$900 \times 4\%$
- (2) In accordance with the equation for computing the indexed adjusted principal of an instrument, the value of the indexed adjusted principal at the beginning of year 2 (end of year 1) is the adjusted principal at the beginning of year 1 grossed up by inflation in year 1 and less the amount of interest excluded from assessable income in year 1 due to the indexation adjustment. This is:  $(\$900 \times 1.04) - \$36 = \$900$ .
- (3) i.e.,  $\$900 \times 7\%$
- (4) The allowance for lending loss exceeds the nominal interest income by \$13. Hence, \$13 of indexation adjustment cannot be used to offset assessable income in year 2.

#### Year 3

Since the taxpayer sells the arrangement for \$1,050 midway through year 3, he or she is required to undertake a cash price adjustment. In respect of the arrangement, the cash price adjustment subjects to tax the real value of the proceeds on disposal and any cash flows received less the cost of acquiring the arrangement and any income that had previously been subject to tax. All of

these amounts are in disposal year dollars.

In effect, the cash price adjustment is the sale price of the asset, minus its indexed adjusted principal at the beginning of year 3 (end of year 2) grossed up by inflation to the time of disposal (i.e. the inflation of 4% for the first six months of year 3).

The indexed adjusted principal of the asset at the beginning of year 3 is the adjusted principal at the beginning of year 2 grossed up by the inflation rate in year 2, minus nominal interest income during the year that is excluded from assessable income. That is:

$$(\$900 \times 1.07) - \$50 = \$913$$

Thus, rounded to the nearest dollar, the amount of taxable income in year 3 is:

$$\$1,050 - (\$913 \times 1.04) = \$100$$

While \$13 of the indexation adjustment in year 2 is not taken into account in that year, in effect it is recognised in year 3 by virtue of being added to the indexed adjusted principal of the asset.



## ANNEX 8.3

### Example of the base price adjustment for an accrual basis taxpayer holding a transferable fixed principal instrument

Suppose X issues to Y six-year debenture stock with a face value of \$1,300 for consideration of \$1,000 at the beginning of year 1. The stock pays nominal interest of \$100 per year for years 1 to 5 in arrears. Midway through the term of the debenture (before the coupon payment is made in the third year), Y sells the stock to a third party for \$1,200. In Y's third year, the base price adjustment will operate to calculate Y's income. The base price adjustment would be computed by reference to the interest flows and real income assessed in each year the arrangement was held by Y. These are given below. Inflation in year one is assumed to be 3%, in year two to be 4% and for the six months to the middle of year three to be 2.5%.

#### Cash Flows and Real Assessable Income - Years 0 - 3

Year	0	1	2	3
Nominal (Acquisition)/ Sale price	(\$1,000)			\$1,200
Nominal Interest		\$100	\$100	
Nominal Accrued Income (1)		\$124	\$128	
Principal Outstanding at beginning of year	\$1,000	\$1,024	\$1,052	
Inflation rate		3%	4%	2.5% (2)
Indexation Adjustment		\$30	\$41	
Taxable Income		\$94	\$87	

#### Notes

- (1) at a YTM of 12.4% per annum  
(2) for the first six months of year 3

All figures are rounded to the nearest dollar for illustrative purposes.

Under the base price adjustment formula,  $a - b - c$  (with all amounts rounded to the nearest dollar):

- a is all amounts paid and payable to Y in constant dollars at the time of disposal. That is the \$100 nominal interest in years 1 and 2 grossed up by the relevant inflation rates and the \$1,200 sale price in year 3. The value of the \$100 of interest received at the end of year 1 in disposal year dollars would be  $\$100 \times 1.04 \times 1.025 = \$107$ . The value of interest received in year 2 in disposal year dollars would be  $\$100 \times 1.025 = \$103$ . That is, the total of all amounts paid and payable to Y would be  $\$107 + \$103 + \$1,200 = \$1,410$ ;
- b is Y's indexed acquisition price, the price paid for the stock in disposal year dollars. The indexed value would be  $\$1,000 \times 1.03 \times 1.04 \times 1.025 = \$1,098$ ; and
- c is income derived less expenditure incurred under the accrual rules in disposal year dollars. That is the \$94 and the \$87 in years 1 and 2 grossed up by the relevant inflation rates. In disposal year terms, the income derived under the accrual rules in year 1 would be  $\$94 \times 1.04 \times 1.025 = \$101$ . In disposal year dollars, the taxable income in year 2 would be  $\$87 \times 1.025 = \$89$ . The total income derived less expenditure incurred would be \$190.

$$\text{Thus, } a - b - c = \$1,410 - \$1,098 - \$190 = \$122$$

A positive base price adjustment is deemed to be income to Y in year 3 under section 64F(4)(a)(i) of the Act. This compares with the income derived without indexation, which is \$148.

In practice, the additional calculation required would be simpler since taxpayers who hold financial arrangements could periodically compute and update the components of the indexed base price adjustment in the same manner that the cost of ordinary capital assets is calculated. The base price adjustment would then simply equal the payment on sale less the carried forward indexed base price of the asset.

# CHAPTER 9: AVOIDANCE AND REVENUE IMPLICATIONS

## 9.1 Introduction

Administrative and compliance costs are not the only factors that need to be considered when assessing the feasibility of indexing the capital income tax base for the effects of inflation. The desirability of inflation indexation also depends on the extent to which indexation would create or exacerbate avoidance problems. In addition, it is necessary to consider the effect indexation would have on the amount of revenue raised by the income tax system. This chapter examines these aspects.

## 9.2 Opportunities for Avoidance

One of the major concerns about indexation is that it might open up avoidance opportunities. Tax-induced changes in behaviour impose real costs on the community by creating inefficient patterns of consumption, production and resource use. They also reduce the amount of revenue raised by the income tax system, thereby requiring higher tax rates which impose even greater efficiency costs on the community and encourage further changes in the behaviour of taxpayers.

To the extent that indexation reduces the effective rates of tax on income from capital in periods of inflation, some reduction might be expected in the potential gains to be derived from avoidance and hence the level of avoidance. However, the introduction of inflation indexation could increase the scope for avoidance.

It is obviously not possible to fully assess the extent to which indexation of the existing income tax base is likely to increase the scope for avoidance. It is, however, possible to identify a number of possible avenues for tax avoidance that would need to be addressed if the existing capital income base were indexed for inflation.

Comprehensive indexation of income from capital introduces two possible opportunities for avoidance. First, indexation would mean that the tax liabilities on capital income are dependent on the date on which capital expenditures are incurred. As a result, tax liabilities can potentially be reduced via manipulation of those dates. Secondly, comprehensive indexation effectively reduces the tax rates imposed on capital income in relation to other forms of income that are ineligible for indexation. This means that tax liabilities on unindexed forms of income can be reduced to the extent that such income can be recharacterised as indexed forms of income. Examples of techniques which could potentially be employed to take advantage of these opportunities for abuse of the tax system are provided below.

### 9.2.1 "Bed and Breakfast" Schemes

Where indexation allowances are based on asset holdings at particular times (e.g. quarters of the year), there would be an incentive for taxpayers to endeavour to increase their allowances, and hence reduce their tax liabilities, by purchasing assets just prior to the relevant dates and selling them just after the commencement of the next indexation period. In this manner, taxpayers could either offset any income or exaggerate the real loss they realise on the sale of the asset by the extent of the increase in their indexation adjustment.

These "bed and breakfast" schemes would be particularly attractive for taxpayers who buy and sell assets where the costs associated with trading and holding are small (e.g., shares, precious metals and tradeable options) and where there is no requirement to hold an asset for a minimum period to be eligible for indexation. Similar opportunities for abuse would arise in relation to financial arrangements if the indexation adjustment depends on the value of net monetary assets assessed at particular points in the year. The attraction of such schemes would diminish, however, where it is relatively easy to distinguish between assets purchased on different dates and where there are significant costs associated with buying, holding and reselling those assets.

In the absence of anti-avoidance provisions, taxpayers who hold these assets as trading stock would have considerable opportunities for avoidance. For example, consider the scope for abuse where average stock levels are below the specified threshold (e.g., \$1 million). In this instance, trading stock would be adjusted for the effects of inflation by allowing a deduction for the average of the opening and closing stocks multiplied by the rate of inflation. There would be an incentive for taxpayers to inflate the value of closing stock by purchasing shares just prior to the end of the income year and selling the shares on the first day of the next income year. This could be achieved through a transaction either between a resident and a non-resident company, or between two resident companies with different balance dates.

If New Zealand's capital income base were to be comprehensively indexed for inflation, it would be necessary to introduce measures aimed at either countering these techniques or at least reducing the incentives for such activity.

Since the gains from "bed and breakfast" schemes are largely dependent on the rate of inflation and the extent to which it is possible to disguise assets acquired on one date as assets acquired on another, the attraction of the above schemes could be substantially reduced by increasing the number of indexation periods per year and requiring assets to be valued on a FIFO basis.

These provisions would not have to be applied to all assets, only to those where the scope for "bed and breakfast" avoidance techniques are the greatest. This includes assets such as shares and options as well as assets such as precious

metals. Similarly, the provisions would not have to be applied to all taxpayers who own these types of assets. Rather, they could be targeted at those taxpayers with the greatest scope for avoidance, that is, taxpayers with average asset holdings or stock levels in excess of a specified threshold (e.g., \$5,000).

Taxpayers who hold other categories of trading stock would still have an incentive to employ "bed and breakfast" schemes to artificially inflate their inflation adjustments. However, attempts to exaggerate indexation adjustments could be deterred by specific anti-avoidance rules such as those currently applying in the United Kingdom.

### 9.2.2 Debt/Equity Swaps

As discussed in Chapter 2, many of the deficiencies of the existing income tax system arise from the differential tax treatment of different forms of income and the practical difficulties associated with trying to distinguish between ordinary income and income on capital account. Even if it were possible to achieve a more comprehensive income tax base by removing the remaining exemptions for certain types of capital income, the comprehensive indexation of capital income would reintroduce a difference in the tax treatment of different forms of income. This would necessitate a clear definition of income that is eligible for indexation. Nevertheless, during periods of rapid inflation, many of the current problems associated with trying to distinguish between different forms of income might be reintroduced. It would be necessary to develop rules to guard against avoidance possibilities before comprehensive indexation could be regarded as practicable.

Any system of indexing interest income and expense for the effects of inflation provides an incentive for taxpayers to avoid tax by re-characterising other forms of income as interest income. If forms of income that are not eligible for indexation (eg wages, fees and commissions) could be re-characterised as interest income, the benefits of indexation would be extended to these forms of income. The possibility of domestic firms lending to foreign firms which return the capital in other forms provides a possible mechanism whereby other forms of income that are not eligible for indexation might be converted into interest and thereby subjected to concessional tax rates.

Under the existing provisions of the Income Tax Act, interest is taxed more heavily than the net returns on most real assets. This means that if a taxpayer borrows from abroad and invests in an asset which generates a pre-tax rate of return which is equal to the interest rate, that company would normally earn a profit as a consequence of the net deduction it obtains. This will tend to increase investment in domestic assets until the pre-tax rates of return (adjusted for risk) are less than the interest rate. National income may be

lowered because of the artificial incentive this provides for borrowing offshore. In addition, taxpayers with relatively low marginal tax rates would be encouraged to decrease their investment in physical assets and increase their investment in debt instruments. This tax-induced bias in investment patterns would tend to increase during periods of inflation.

Comprehensive inflation indexation of capital income would tend to reduce the gains from avoidance activity and the resultant investment bias during periods of inflation. However, indexation would continue to provide an incentive during periods of inflation for taxpayers to employ techniques like those outlined above as a means of obtaining indirect indexation of other forms of income that are ineligible for indexation.

There are two important observations that need to be made in relation to these avoidance techniques. First, in relation to the potential benefits to be derived, the techniques would expose the resident taxpayer to considerable risk to the extent that the non-resident party to the agreement could either default, or the transaction could be voided by section 99. Second, the scope for such techniques would be considerably reduced if companies were to be taxed on any gains that were akin to "borrowing" gains described in Chapter 8 realised on the redemption of a particular class of shares, and if deductions for certain loans made at negative real interest rates were to be denied.

The denial of all negative real interest deductions would not only reduce the gains from tax avoidance, but it would also in effect tax those forms of "imputed" income that are often provided to lenders in exchange for loans at negative real interest rates. However, as discussed in Chapter 8 this approach may also have some unintended consequences. Consequently, as outlined in that Chapter, where the holder of a financial arrangement makes a real loss, the loss should be deductible if it can be demonstrated that the instrument offered a normal commercial arm's length yield that could reasonably have been expected to be positive in real terms when acquired by the holder.

In summary, the net effect of comprehensive indexation of capital income on the scope for tax avoidance is difficult to determine. Although indexation would reduce the potential gains to be made by avoiding tax on capital income during periods of inflation, it would also increase the effectiveness of existing avoidance techniques and introduce new opportunities for avoidance. The scope for such activity could be reduced to some extent by requiring taxpayers whose trading stock includes equity instruments (e.g., shares and options) and precious metals in excess of a specified threshold (e.g., \$5,000) to use a FIFO approach to value those assets and use daily indexation factors to adjust the income derived from such assets for the effects of inflation. Deductions for interest expense for certain loans that have been made at negative real rates of interest could also be denied, and companies could be taxed on any gains made on the redemption of a particular class of shares. Any remaining opportunities for avoidance could be countered via a specific anti-avoidance rule.

### 9.3 Revenue Implications

When assessing the desirability of any movement towards a real income tax base, it is also important to consider the extent to which this would conflict with the basic objectives of the income tax system - to raise the revenue necessary to fund government expenditure.

It is inevitable that comprehensive indexation of the income tax base would initially reduce tax revenue. Before examining the revenue implications of indexing the existing capital income base for the effects of inflation, however, it is important to note that the main objective of reforming the taxation of income from capital is not to raise revenue, but rather to improve the ability of the income tax system to raise revenue at the lowest possible cost to the community.

As a result, it is not possible to assess the desirability of reforming the taxation of capital income simply by comparing the revenue raised by such reforms. It is also important to consider the extent to which the efficiency of the income tax system has been improved, even though such improvements are much more difficult to observe than either the administrative and compliance costs and the revenue raised by the reforms. An example of this is the introduction of imputation. Even though this measure resulted in the loss of government revenue, this was desirable because it reduced the overall costs imposed on the community by the income tax system.

Similarly, even if the indexation of capital income initially resulted in a net reduction in government revenue, such a reform may still be desirable. This is because the efficiency costs associated with raising any shortfall in revenue may be considerably smaller than those associated with continuing to raise this amount of revenue by in effect imposing an uncertain and discriminatory wealth tax on certain forms of capital during periods of inflation. In addition, a more efficient tax system will tend to promote growth by encouraging more efficient patterns of savings and investment, thereby increasing the scope for future revenue collections or reductions in tax rates.

Table 9.1 outlines the estimated long-run tax effects that comprehensive indexation of the income from capital would have on annual revenue collections under a variety of inflation rates.

**TABLE 9.1**  
**Long-Run Tax Revenue Effects of**  
**Comprehensive Indexation**

	Inflation Rate		
	2%	4%	6%
Indexing Depreciation (corporate sector only)	-\$20m	-\$40m	-\$55m
Indexing Trading Stock (corporate sector only)	-\$105m	-\$210m	-\$310m
Indexing Financial Arrangements	-\$25m	-\$40m	-\$50m

Considerable caution should be exercised when interpreting the results of Table 9.1 because the estimates are subject to a substantial margin of error. They are based on incomplete information. Firstly, data on depreciation, stock and financial arrangements are only available for the corporate sector. Thus, the impact on the non-corporate sector is difficult to estimate and not reported (with the exception of the financial arrangements associated with farming). The exclusion of the non-corporate sector will tend to understate the revenue loss. Secondly, the estimates have not been adjusted for the income derived by companies in tax loss. This will tend to overstate the revenue loss.

## 9.4 Conclusion

The effects of comprehensive indexation of capital income on the scope for tax avoidance are difficult to determine. To the extent that indexation would prevent the overtaxation of capital income in times of inflation, it would reduce the incentive for tax avoidance. At the same time, however, in the absence of anti-avoidance provisions, comprehensive indexation of the tax base may tend to increase the scope for avoidance by increasing the effectiveness of existing avoidance techniques and introducing new opportunities for avoidance.

The scope for avoidance activity could be reduced to some extent by requiring taxpayers whose trading stock includes equity instruments (e.g., shares and options) and precious metals, in excess of a specified threshold (e.g., \$5,000), to use a FIFO approach to value those assets and use daily indexation factors to adjust the income derived from such assets for the effects of inflation. Further reductions in the scope for avoidance could be obtained by denying deductions for interest expense for most loans that have been made at negative real rates of interest and by taxing companies on any gains made on the redemption of particular classes of shares. Any remaining opportunities for avoidance could be addressed through the use of specific anti-avoidance rules such as those currently applying in the United Kingdom.



The comprehensive indexation of the capital income base would also initially reduce tax revenue to some extent as well as the amount of tax revenue raised by a given percentage point increase in tax rates. However, in so doing, it should also increase the efficiency of the tax system. This is because it would virtually eliminate the varying rates of implicit wealth tax that is currently imposed by the income tax system on capital income and expenditure during periods of inflation.



# CHAPTER 10: DIRECTIONS FOR REFORM

## 10.1 Introduction

The results of the analysis in this part of the Document suggest that the comprehensive indexation of capital income and expenditure is worth pursuing. The indexation of capital income and expenditure incurred in relation to assets that produce taxable profits on disposal and depreciable assets is relatively straightforward and is unlikely to unduly increase costs of administration and compliance. The indexation of trading stock and of financial arrangements is more problematic, but at this stage it also appears to be feasible.

Nevertheless, since comprehensive indexation of capital income would be a major reform, its feasibility warrants a detailed investigation during the consultative process. In the event that further investigation of comprehensive indexation suggests that it is not feasible or that it cannot be implemented in one step, consideration would have to be given to either partial indexation or a phased introduction of comprehensive indexation. In either case, some modification of the indexation proposals outlined in Chapters 5 to 9 may be necessary.

This chapter examines a number of partial approaches to the introduction of indexation and identifies a number of modifications that would be required to the proposals in earlier chapters if indexation were restricted to certain forms of capital income.

## 10.2 Possible Approaches to the Implementation of Indexation

There are several possible approaches to the implementation of comprehensive indexation. Of these, three approaches warrant particular attention. They are the deferral of indexation until it is possible to comprehensively index the entire capital income tax base; the indexation of those forms of capital income and expenditure that are currently excluded from the tax base; and the indexation of capital income and expenditure incurred in relation to physical assets.

### 10.2.1 Defer Indexation of Capital Income and Expenditure

In view of the practical difficulties associated with indexing financial arrangements and the benefits to be derived from comprehensive rather than partial indexation of the capital income base, one possible approach is to defer indexation entirely until the remaining practical problems have been resolved.

The main problem with such an approach is that it is more practical to move towards indexation at the same time as the current exemptions are removed. Many countries have attempted to remove the remaining anomalies in their capital income bases by taxing nominal gains realised on the sale of assets. However, these attempts have resulted in tax systems that still retain a wide range of concessions in the form of exemptions, roll-overs or concessional rates of tax.

Although the intent of such concessions is not always clearly stated, one of the major purposes appears to be to ensure that capital income is not overtaxed during times of inflation. This "de facto" indexation is, of course, inefficient since it provides the same relief regardless of the rate of inflation, it may increase lock in and encourage investment in relatively unproductive assets. Such concessions also add considerable complexity to the income tax system and usually prove difficult to remove even if indexation is subsequently introduced. For example, the United Kingdom originally introduced a tax on nominal gains that eventually contained a wide range of reliefs. These were not subsequently revoked following the introduction of indexation. Similarly, the United States currently taxes nominal gains but is now considering either a reduction in the rate of tax on capital gains or the introduction of inflation indexation as a means of avoiding the overtaxation of capital income during periods of inflation.

Chapter 17 of this Document outlines the transitional provisions that could be applied to facilitate the removal of some of the remaining income tax exemptions. The complexity of the transitional provisions would increase considerably if, during the transition, attempts were made to index this income for the effects of inflation. This complexity would be a further source of inefficiency and administrative and compliance costs. Many of the administrative and compliance problems experienced by other countries with the indexation of capital gains are the result of the failure to integrate the capital gains tax regime and indexation, thereby necessitating the introduction of complex transitional rules.

In summary, international experience casts doubt on the desirability of attempting to extend the tax base to include capital gain income while deferring the introduction of indexation. Not only does such an approach inhibit progress towards removing remaining the anomalies in the capital income tax base, it also adds complexity to the income tax system and increases the administrative and compliance costs of introducing inflation indexation at a later date.

### **10.2.2 Indexation of Income Currently Excluded From the Base**

An alternative approach would be to initially index those forms of capital income and expenditure that are currently excluded from the income tax base and extend indexation to other forms of capital income at some later date.

Although the restriction of indexation to certain forms of capital income is clearly inferior to comprehensive indexation, it would nevertheless result in a significant improvement in the tax system if it could be introduced without administrative and compliance problems. The failure to index interest income and expense would not introduce any new distortions into the income tax system, while the inclusion in the income tax base of those forms of capital income that are currently exempt would significantly improve the efficiency of the income tax system even if they were indexed for inflation.

Such an approach would permit the taxation of currently exempt forms of income while limiting pressures to provide special reliefs such as lower tax rates and exemptions to mitigate the impact of inflation. This would also facilitate any subsequent moves to index the rest of the capital income base.

Significant inequities and inefficiencies in the income tax system would, however, still remain. Other business and investment income would continue to be taxed on a nominal basis. As a result, during periods of inflation the income tax system would still favour investment in assets that produce indexed forms of capital income over investment in other assets that produce annual cash flow income. Nevertheless, the degree of bias would be reduced by taxing indexed gains.

The major problem associated with partial indexation of the capital income base is the arbitrary nature of the distinction between indexed and non-indexed capital income. As discussed in Chapter 9, once any form of capital income is indexed for the effects of inflation, there would be a continuing incentive for taxpayers to recharacterise other forms of income as income eligible for indexation. This would not only result in the indirect indexation of forms of capital income that are not eligible for indexation, but it could also result in the indexation of income that is not affected by inflation.

### **Implications for the Treatment of Shares**

One problem associated with partial indexation is the treatment of shares. Suppose that all profits realised on the sale of shares were taxable but on an indexed basis while income derived from financial arrangements is not indexed. This would encourage taxpayers to hold financial arrangements in companies rather than invest in financial arrangements directly, since any gains realised on the sale of company shares would be indexed for the effects of inflation.

One possible solution to this problem would be to adopt a somewhat different approach to the indexation of shares than that outlined in Chapter 5. Rather than require shareholders to index the original cost of their shares for the effects of inflation, companies could be allowed to create a separate "indexation

account" and credit income in the form of inflationary gains realised on the sale of assets to that account. This exempt income could then be passed on to shareholders tax free.

This approach would allow companies to pass through credits for any tax paid on indexed gains realised on the sale of real assets. In addition, it would avoid the need for individual shareholders to index the cost of their shares for inflation and reduce the need to subject shares to special rules to prevent abuse of the indexation provisions.

An alternative approach would be to allow only nominal and not real losses on shares to be deductible.

### **Implications for the Treatment of Depreciable Assets**

Similar problems could be encountered in trying to prevent the extension of indexation to depreciation allowances. For example, consider the difficulty associated with taxing inflation indexed profits realised on the sale of commercial property while attempting to deny indexation for depreciation deductions. By selling and repurchasing depreciable assets, taxpayers could obtain the benefits of indexation because the sale of an asset would give rise to taxable income only if the sale price exceeds the inflation-indexed cost. However, the sale of the asset increases the cost base for future depreciation deductions by the full amount of the nominal gain.

For example, consider the case of an asset with an annual depreciation allowance of 20% of the initial cost of the asset, less previous depreciation deductions. If the asset is originally purchased for \$100, the taxpayer can claim deductions of \$20 and \$16 in the first two years, reducing the book value at the end of two years to \$64. Assume that the allowable depreciation rate accurately reflects the annual decline in the real value of the asset, but that only income realised on the disposal of that asset, not depreciation, is indexed for the effects of inflation. Assume also that the annual rate of inflation is 10% over the period. The asset's market value at the end of two years would be \$77.44. If the asset were sold, the book value would be adjusted to \$77.44 (\$64 multiplied by an inflation factor for 2 years of 1.21) and there would be no assessable income realised on the disposal of the asset. The depreciation deduction in the following year would be raised, however, from \$12.80 (20% of \$64) to \$15.49 (20% of \$77.44) - exactly the result that would occur if depreciation were indexed.

Although such avoidance activity is specifically prohibited at the moment by section 111 of the Income Tax Act, it would nevertheless be difficult to detect.

The problems outlined above arise from the fact that there is no inherent logic the distinction between currently taxed and untaxed forms of income.

Accordingly, an alternative and preferable approach would be to index income derived from all physical assets, but continue to tax nominal income derived in relation to financial arrangements. Shares would be partially indexed in the manner outlined above. This approach is examined below.

### **10.2.3 Index Physical Assets but Exclude Financial Arrangements**

If the remaining issues concerning the indexation of financial arrangements cannot be resolved during the consultative process, it may be preferable to index income produced by physical assets, but not interest income and expense until the issues can be resolved.

This approach appears to offer a number of advantages over the limitation of indexation to assessable gains. It would ensure that the income from all physical assets was adjusted for the effects of inflation. As discussed in Chapters 6, 7 and 9, it appears that depreciable assets and trading stock could be indexed without an excessive increase in administrative and compliance costs.

However, some of the efficiency gains of indexation would be lost due to the continued tax treatment of interest income and expense on a nominal basis. As discussed in Chapter 9, the existing provisions of the Income Tax Act provide an incentive for taxpayers on low marginal tax rates to invest in financial arrangements and for taxpayers on high rates to gear up and invest in physical assets, especially those that generate exempt income. Moreover, inflation tends to increase this investment bias by increasing the effective rates of tax imposed on interest income and increasing the inflationary borrowing gains of borrowers.

In some respects, the effects of restricting indexation to physical assets are similar to the effects of accelerated depreciation and investment allowances. During periods of inflation, a system of partial indexation would make highly-g geared investment in physical assets even more attractive to taxpayers on high marginal tax rates since the assessable income derived from those assets would be reduced by indexation, but the inflationary component of nominal interest expense would still be deductible and nominal interest income would still be taxable. Taxpayers on high marginal tax rates would have an incentive to gear up until nominal interest rates and risk exposure increase sufficiently to offset the tax advantages from further borrowing. This process would tend to distort patterns of investment and reduce tax revenue to the extent that a greater proportion of nominal interest expense was claimed by taxpayers or high marginal rates.

However, given that the bulk of investment is undertaken by taxpayers with marginal rates of tax of either 28 or 33% and assuming the maintenance of relatively low rates of inflation in the future, the extent of this reduction in

economic efficiency and tax revenue may be relatively small in relation to the substantial efficiency gains from indexing income from physical assets for the effects of inflation.

Furthermore, as noted in previous chapters, even moderate rates of inflation can substantially raise effective tax rates on real income from capital. In the absence of indexation, considerable pressure for ad hoc relief measures, such as accelerated depreciation allowances and investment incentives, can arise. The incentives for arbitrage under a partial indexation system would reduce with reductions in the rate of inflation. As a result, although indexation of physical assets is clearly less desirable than a system of comprehensive indexation, it may be preferable to an approach that restricted indexation to assessable gains.

### 10.3 Conclusion and Summary of Desirable Reforms

One of the major remaining deficiencies of the income tax system is its failure to adjust capital income and expenditure for the effects of inflation. An income tax tends to overtax capital income in times of inflation, creating disincentives to saving and investment. Of equal concern is the tendency of the tax system to distort patterns of saving and investment during times of inflation.

In principle, these tax-induced distortions in the pattern of investment during periods of inflation could be eliminated by moving the existing income tax system onto either a real or a nominal basis. Under a nominal income base, however, there would still be a substantial tax-induced disincentive to save or invest during periods of inflation. This suggests that the most appropriate goal for future reform is a real income tax base.

In practice, an approximation to a real income base could be achieved by comprehensive indexation of capital income and expenditure for the effects of inflation. This would involve indexation of income and expenditure incurred in relation to assets that yield assessable profits on disposal, trading stock, depreciable assets and financial arrangements.

Comprehensive indexation of the entire capital income base would be a major improvement in the tax system. It would improve the efficiency of the tax system during periods of inflation, albeit at the expense of some increase in administrative and compliance costs and a reduction in government revenue.

The indexation of capital income and expenditure incurred in relation to assets that produce assessable gains, trading stock and depreciable assets appears to be relatively straightforward and is unlikely to substantially increase administrative and compliance costs. The indexation of financial arrangements is more problematic, but at this stage it also appears to be feasible.



Given their significance, the indexation proposals warrant a detailed investigation in the consultative process. This should also provide a useful vehicle for advancing consideration of indexation. Even if it is concluded that it is not appropriate to index financial arrangements at this stage, some partial indexation of the capital income tax base appears to be both feasible and desirable pending resolution of the problems associated with indexing financial arrangements. As noted in this chapter, however, some modification of the indexation proposals may be necessary if inflation indexation is initially limited in scope.

### **Physical Assets Producing Profits on Disposal**

Physical assets which produce assessable gains on disposal could be indexed in the manner outlined in Chapter 5. That is, taxable income derived on the sale of these assets would be calculated by deducting their indexed cost from the proceeds received. Individuals and companies would be able to adjust the income derived on the disposal of such assets for the effects of the inflation that has occurred in each full quarter since the purchase of the asset.

### **Trading Stock**

Income produced by trading stock could be adjusted for the effects of inflation in the manner described in Chapter 6. This would involve the estimation of the average value of trading stock over the accounting period and the provision of a deductible inflation allowance for the effects of inflation over the period.

Under this approach, the majority of taxpayers who currently employ relatively unsophisticated inventory systems would be able to calculate the average value of their stocks on the basis of a simple average of the opening and closing stock. Taxpayers who currently employ more sophisticated inventory systems (e.g. those with average stock levels in excess of, say, \$1 million) could be required to calculate the average value of their stock as the average value of their quarterly stock levels (expressed in end of year dollars).

### **Equity Instruments and Precious Metals**

Taxpayers who own more than a specified value (e.g., \$5,000) of equity instruments (e.g., shares and options) or precious metals would be required to value those assets on a FIFO basis and index the income derived for the effects of inflation between the day of purchase and the day of sale (i.e., daily indexation factors would be employed).

## **Depreciable Assets**

Depreciation allowances could be adjusted for the effects of inflation in the manner outlined in Chapter 7. This would involve the calculation of depreciation allowances on the basis of the historical cost depreciated book value of the asset adjusted for the effects of inflation.

## **Financial Arrangements**

The mechanics of indexing debt instruments were outlined in Chapter 8 in relation to three major types of instrument - variable principal instruments, non-transferable fixed rate instruments and tradeable fixed rate instruments. The reforms outlined preserve the current distinction between accrual and cash basis taxpayers. One of the main principles behind the reforms is that the inflationary component of interest income/expense should be taken into account in computing assessable income only when income or expense is recognised for tax purposes.

Broadly, cash basis holders of debt instruments could compute the amount of nominal interest to be excluded from assessable income either by:

- multiplying the minimum or average cost (or principal) of the instruments during the period to which interest payments relate by the inflation rate for the period; or
- reducing their nominal interest receipts by a published standard fraction. The standard fraction would be an estimate of the inflationary component of the average interest rate on common debt instruments.

In many instances, financial institutions may compute the indexation adjustment as a service for their customers.

Accrual basis holders or issuers of variable principal instruments could accrue amounts to be excluded from nominal interest income/expense in relation to any income year based on:

- the average daily balance of instruments during the year;
- the minimum daily balance during the year in respect of instruments they hold; or
- the maximum daily balance during the year in respect of instruments they have issued.

In respect of fixed rate instruments, accrual basis taxpayers would compute the indexation adjustment based on the accrued principal outstanding for the accounting period multiplied by the corresponding inflation rate.

The computation of the base or cash price adjustment under the accrual rules is particularly important in relation to tradeable instruments. These adjustments would be computed in current dollars at the time an instrument is sold or matures.

Negative real interest would not be deductible other than where a taxpayer can establish that the instrument offered a normal arm's length commercial yield when it was acquired.



## **PART III: REMOVAL OF EXEMPTIONS**

### **A: POLICY ISSUES**



# CHAPTER 11: OVERVIEW

## 11.1 Introduction

As discussed in Part I of this Document, there are a number of sources of non-neutrality in the present system of taxing income from capital, two of which are dealt with in this document. First, inflation affects different types of assets differently with the result that effective tax rates diverge, the more so the higher the rate of inflation. Secondly, some types of income are untaxed, including income "on capital account", some of which is more commonly referred to as "capital gain", as well as a wide range of non-market income.

Part II canvassed the way in which the inflation-induced distortions might be addressed. This part of the Document discusses the removal of specific exemptions. This is intended to address the problems with the present tax system that were outlined in Chapter 2 and discussed in more detail in Chapter 3. In essence, the problem is non-neutrality - the diversion of investment into areas that produce untaxed income at the expense of investment in other areas that produce higher returns to the nation as a whole. Equity concerns may also be an important motive for reform, particularly since public perceptions about the fairness of the tax system are important.

Nevertheless, reforms can have costs as well as benefits. The relative merits of removing exemptions depend on the costs and benefits of doing so. Accordingly, this part of the Document aims to set out the main policy issues that must be addressed in extending the present tax base to include presently untaxed forms of income. An outline of the practical detail of such an approach is left to Part IIIB.

There are three main arguments advanced against removing the present exemptions. First, it is sometimes argued that profits derived on the disposal of property (i.e, capital gains) are not "income" - that a tax on such profits is a tax on "capital". Secondly some argue that the removal of capital income exemptions is unnecessary because capital gains are already implicitly taxed through the eventual taxation of the future cash flows capitalised by such gains. Thirdly, it is argued that the taxation of these profits would discourage savings and investment. This chapter first addresses these three arguments.

## 11.2 Distinction Between Income and Capital

It is sometimes said that the taxation of profits or income derived on the disposal of property would "tax capital". To evaluate this statement, it is necessary to define what is meant by the terms "income" and "capital". The distinction between these two terms is easily seen by considering, say, a term deposit in a bank. Assume that X invests \$1000 for 12 months at an interest

rate of 10% per annum. At the end of the 12 month period, X will have earned \$100 (i.e., 10% of the \$1000 invested). X's capital at the start of the period is the amount invested - \$1000. The income that X earns during the period is the interest on the deposit - \$100. If X spends all of the \$100 of income, his or her capital at the end of the period would remain \$1000. Conversely, if X reinvests the \$100, his or her capital will have increased to \$1100.

As this example illustrates, capital is a "stock" - a stock of money or other assets - whereas income is a "flow", the return produced by capital. Another example often used to illustrate the difference between income and capital is an orchardist's fruit trees and the fruit they produce. The fruit trees are the orchardist's capital - they are not sold to produce income, but are retained for year after year (until they need to be replaced) in order to produce fruit. The fruit is the orchardist's income - the flow of goods (or services) produced by his or her capital.

More generally, capital is anything that produces a flow of goods or services in the future (whether or not those goods or services are in the form of money or can be sold for money). The term "capital gain", as the name suggests, means an increase or gain in the value of an item of capital (i.e., an asset). A tax on capital gains is therefore a tax on the change in the value of items of capital. It is not a tax on the capital stock itself. For example, assume that a building increases in value from, say, \$50,000 to \$70,000 over a certain period. The capital gain on the building is the increase in its value. This is calculated as \$70,000 less \$50,000, or \$20,000. Alternatively, assume that the value of the building at the start of the period is, say, \$200,000 and that this increases to \$220,000. In both cases, the capital gain is \$20,000.

These examples have been chosen to illustrate the point that the amount of any capital gain from holding an asset depends on the change in the value of the asset, not on its initial value alone.

Changes in the value of capital are included within a comprehensive definition of income. In economic terms, a person's income in any period is defined as the sum of the amount they spend on consumption in the period and the change in the person's real net worth. The person's net worth, in turn, means the market value of his or her total capital (or total assets) less the market value of his or her liabilities. For example, if X has assets with a total value of, say, \$100,000 but total liabilities of \$70,000, X's net worth is \$30,000 (i.e., \$100,000 less \$70,000). Since increases in the value of property held increase net worth, they are included within this definition of income.

It does not matter, for example, whether a person earns \$100 income as interest from government stock, as dividends or as "capital gain" from a company that invests in government stock. The person's net worth has increased by the amount and they are better off by that amount.



As noted above, an income tax is not a tax on capital or wealth. An example of a capital tax is land tax. This is a tax on a stock of capital, in the form of land liable for land tax, rather than a tax on the change in the value of land. The general term "capital tax" means a tax on a stock of capital, irrespective of any changes in its value.

## **11.3 Will Removal of the Exemptions "Double Tax" Capital Income?**

### **11.3.1 Overview**

It is sometimes argued that the removal of the present capital income exemptions is both unfair and inefficient because a tax on capital appreciation will be additional to the subsequent taxation of the future cash flows that are capitalised by that appreciation.

Specifically, it is alleged that capital gains do not escape taxation, even under tax systems which exempt such gains, because these gains are implicitly taxed through the eventual taxation of the future cash flows capitalised by the capital gain. Since capital gains are already implicitly taxed, so this argument goes, it is unnecessary, unfair and inefficient to subject such gains to additional taxation by an explicit tax on capital appreciation.

In order to evaluate this argument, it is necessary to identify the conceptually distinct sources of capital appreciation and to examine the validity of the argument in relation to each of them. The important sources of capital gain considered below are systematic capital gains on maturing assets, systematic "goodwill" gains and unexpected or "windfall" gains.

Since the analysis is intended to clarify certain fundamental conceptual issues, it proceeds at a level of abstraction appropriate to this objective. Thus, the analysis abstracts from the design details of the tax system and assumes that capital appreciation is taxed as it accrues and that gains and losses are taxed in a fully symmetrical manner. Similarly, the discussion makes no specific reference to inflation and may be interpreted either as assuming its absence, or as referring to dollars of constant purchasing power and real rates of interest under an indexed tax system. Finally, while the conclusions of the analysis are quite general in the sense that they hold independently of the actual pattern of cash flows generated by an asset, the illustrative examples postulate the simplest cash flow pattern required to distill the essence of the argument.

Since the question at issue is the consequences of treating capital appreciation and depreciation as part of capital income under an income tax, it is useful to take as a benchmark an asset which is not expected to yield any capital gains or losses and for which all expected income is therefore on revenue account.

A concrete example of such an asset is a perpetuity yielding a constant cash flow of \$10 per annum. At a constant interest rate of 10% per annum, the capital value of this perpetuity would be expected to remain constant over time at \$100.

As discussed in Chapter 3, the economic income generated by any asset is defined as the largest flow of current consumption that the asset could support, subject to the constraint that its capital value remains intact. Because of its constant capital value, the flow of economic income generated by a perpetuity consists only of cash flow. More complex assets that produce cash flows that are not constant over time will typically be expected to appreciate or depreciate in value. For these assets, economic income, being the algebraic sum of the cash flow and capital gain, will differ from cash flow by the appreciation or depreciation of the asset.

A comprehensive income tax levied at a rate of, say, 25% would reduce the post-tax cash flow of the perpetuity to \$7.50 per annum and the post-tax interest rate to 7.5% per annum. Capitalising the post-tax stream of returns at the post-tax interest rate, the value of the perpetuity will be \$100 - the same valuation arrived at by capitalising the pre-tax cash flow at the pre-tax interest rate.

It is the hallmark of a comprehensive income tax that the wedge it creates between pre-tax and post-tax rates of return on an investment depends only on the tax rate and is independent of the pattern of cash flows generated by the investment. Asset valuations under a comprehensive income tax are therefore the same when conducted in pre-tax or post-tax terms. This implies that under a comprehensive income tax, investors will place the same valuation on expected future cash flows despite differences in their (time independent) marginal tax rates. Thus, investors subject to a 33% marginal tax rate will also value the perpetuity at \$100 since they will capitalise a \$6.70 post-tax cash flow at a post-tax interest rate of 6.7% per annum.

Because the perpetuity involves no element of expected capital gain or loss, its tax treatment will be unaffected (windfalls aside) by whether or not the income tax base includes capital gains and losses. The example of the perpetuity therefore emphasises the sense in which an income tax inherently involves "double taxation". The double taxation inherent in an income tax arises because, under such a tax, assets are purchased out of post-tax income (because the purchase price cannot be immediately deducted) while the income that they subsequently generate is taxed. Realisations of capital (as distinct from increases in capital value) are, of course, exempt from taxation under an income tax regime.

It is this inherent double taxation that reduces post-tax rates of return below pre-tax rates of return. Any impact of the income tax on saving incentives, discussed in section 11.4 below, flows directly from the reduction in the post-

tax rate of return relative to the pre-tax rate of return. It is important to note that if this form of double taxation were removed by, for example, allowing the purchase price of an asset to be deducted, pre-tax and post-tax rates of return would remain equal and the "income tax" would not tax normal rates of return on capital at all.

The purpose of the present discussion is to examine whether the taxation of capital gains (and the recognition of capital losses) introduces any unfair or distorting further element of double taxation (triple taxation?) additional to that inherent in the application of the income tax to a perpetuity where no question of expected capital gains or losses arises.

The efficiency case for comprehensively taxing the economic income from capital rests on the need to ensure that all assets are purchased out of post-tax income and on the desirability of providing uniform income tax treatment for capital assets, regardless of the wide, but economically irrelevant, differences in their patterns of expected cash flows. The objective of defining the tax base to include changes in capital value as well as cash flow is to ensure that all assets receive the same tax treatment as a perpetuity for which all expected economic income is unambiguously on revenue account.

The greater the extent to which the ideal of uniform taxation of economic income is compromised, the larger will be the degree to which arbitrary differences in cash flow patterns will generate arbitrary differences in the burden of taxation. Where real assets are concerned, deviations from the uniform taxation of economic income will result in an economically inefficient pattern of capital accumulation. For financial assets, such deviations will constitute an invitation to tax avoidance - a problem which the accrual rules are designed to address.

The remainder of this section examines the manner in which the removal of capital income exemptions implements these principles in relation to the three important sources of capital appreciation identified above.

### **11.3.2 Maturing Assets**

Assets with cash flows which are heavily concentrated in the future will systematically appreciate in value as they approach maturity. Typical examples are growing forests, maturing wine, or land at the fringes of an expanding city.

Another example of a maturing asset is a deep discount bond promising a single cash payment of \$272 in 10 years time. Like the earlier perpetuity, this asset will have a present value of \$100 when capitalised at an interest rate of 10% per annum. Despite its zero present cash flow, this asset will also generate annual economic income of \$10 per \$100 of capital value. Unlike the

perpetuity which generates economic income consisting only of cash flow with no capital appreciation component, the annual economic income of the zero coupon bond materialises entirely in the form of capital appreciation without any element of cash flow.

The notion that taxing the accruing capital gain on a maturing asset involves any element of double taxation inconsistent with income tax principles is obviously false. If the tax on the accruing gain is levied continuously year by year, the asset will receive exactly the same tax treatment over time as the perpetuity. In the final period, when the single terminating cash flow of \$272 falls due, either of two approaches would ensure that there is no double taxation. First, the tax rules could ensure that income received is untaxed to the extent to which it has been taxed as it accrued. Alternatively, the terminating payment of \$272 could be made taxable but, in addition, a deduction could be allowed for the capital loss of \$272 suffered as the bond expires. Under either approach, it is simply not true that tax on the accruing capital gain is additional to tax on the ultimate cash flow capitalised by those gains.

### 11.3.3 Goodwill Gains

Another important source of capital appreciation is so-called "goodwill gains". When an individual builds up a business, he or she creates an asset with a value exceeding the replacement cost of the associated tangible capital. This excess value, or "goodwill", represents the market's capitalisation of the systematically greater earnings of an established business relative to an otherwise comparable new business.

The taxation of goodwill gains is sometimes alleged to be a deficiency of a capital gains tax. The defect is again claimed to lie in double taxation, first of the goodwill gain and then of the income that the goodwill asset subsequently yields over time. To evaluate this argument, assume that by sacrificing current pre-tax earnings of \$100 or by incurring tax deductible expenditure of \$100 an individual is able to create a goodwill asset which promises a cash flow of \$9 in perpetuity. If the relevant pre-tax interest rate is 10%, the goodwill gain would be worth \$90 to the economy. This goodwill investment is clearly economically unsound since it destroys net value of \$10. In the absence of all taxes, this goodwill investment would also be financially unattractive.

Now assume that a 25% tax rate applies to earnings on revenue account. Given this tax, the opportunity cost of the investment falls to \$75 in post-tax terms. If the cash flow generated by the investment is also taxed at 25%, it will also be lower at \$6.75 (ie,  $(1-0.25) \times \$9$ ). Capitalised at the post-tax interest rate of 7.5%, the cash flow stream of the goodwill asset has a present market value of \$90. In the absence of a tax on goodwill gains, it is clear that the opportunity to invest \$75 of forgone post-tax earnings to generate an asset worth \$90 will appear attractive, despite the evident economic waste involved.

If, however, the gain on the goodwill asset is subject to tax at a rate of 25%, the investor will be led to compare \$75 of forgone post-tax earnings with a post-tax gain of only \$67.50 (ie,  $(1-0.25) \times \$90$ ). Market signals will now faithfully reflect the underlying economic reality and counsel against the investment. To be profitable to the investor when the goodwill gain is taxed, the investment would need to offer a post-tax gain in excess of \$75. It will only do that if it generates a pre-tax cash flow greater than \$10 and thus a capital value greater than the \$100 of forgone pre-tax earnings required to create the goodwill asset.

As this example illustrates, the taxation of goodwill gains does involve double taxation. But this double taxation is no different to the double taxation inherent in an income tax. In relation to goodwill gains, tax compensates for the fact that, in the absence of the tax, goodwill investment would effectively be made out of pre-tax income whereas competing capital investments must be purchased out of post-tax income. The double taxation implied by the taxation of goodwill gains is therefore a requirement of, not an impediment to, economic efficiency.

#### 11.3.4 Windfall Gains

The analysis has to this point considered systematic or expected gains. A separate category of gains are the unexpected or windfall gains and losses arising from revisions of expectations. To analyse the taxation of windfall gains, consider the earlier example of a perpetuity yielding \$10 per annum before tax and capitalised at \$100 at a 10% pre-tax interest rate.

To take a dramatic example of unexpected asset appreciation, suppose that the expected perpetual cash flow suddenly doubles to \$20 per annum. With a 25% tax rate, the post-tax cash flow also doubles, rising from \$7.50 to \$15, as does the Government's annual tax take, which goes from \$2.50 to \$5. Capitalised at 7.5%, the increased \$15 post-tax cash flow will sell for \$200 in the market. Because the revision of expectations has doubled the price of the asset, holders will receive a capital gain of \$100 and will incur a \$25 tax liability. The tax revenue on the gain accruing to the Government is additional to the doubled flow of income tax accruing as a result of the shift in expectations.

The taxation of the windfall gain clearly involves an additional element of taxation. This extra taxation arises because a comprehensive income tax taxes unexpected pure capital profits as well as on-going capital income flows. Several aspects of this element of additional taxation deserve comment.

First, the application of a comprehensive capital income tax to windfalls is symmetrical. If expectations had been revised downwards, the resulting capital losses would reduce the asset holder's tax liabilities. Second, the revision of expectations does not alter the relationship among pre- and post-tax rates of return. Capital values respond to the changed state of expectations so that the

asset continues to yield 10% per annum before of tax and 7.5% per annum after tax. This rule applies regardless of whether unexpected capital appreciation is taxed. In other words, in its application to windfalls, the taxation of the capital gain operates as a lump-sum tax having no efficiency implications. It follows that while there is no efficiency case for applying the capital gains tax to windfalls, there is also no efficiency case against this aspect of the tax.

This shifts the argument to the question of fairness. In the example analysed above, the windfall capital gain, if untaxed, clearly permits the holder of the asset to enjoy a net additional \$100 of consumption while maintaining the capital value of the asset intact. That is, after the revision of expectations, the asset holder can sell half the asset for \$100, using the remaining half to preserve the previous post-tax income stream of \$7.50 per annum. The \$100 gain is therefore equivalent to additional income accruing from any other source. Equity considerations suggest that the unexpected gain should not be treated differently from other income for tax purposes.

Most important of all is the fact that while the distinction between anticipated and unanticipated capital gains is conceptually useful, there is no easy way of making it operational in practice. That is, it would not be practical to attempt to decompose observed capital gains into their expected and unexpected components. While there is no efficiency imperative for imposing a capital gains tax on windfalls, there is also no practical method, short of exempting all capital gains from the income tax base, of exempting unexpected capital gains. Total exemption of capital gains would mean that expected capital gains on maturing assets and goodwill investments would avoid the tax net. This would have unfavourable efficiency implications.

Those who object to the additional taxation of windfall gains by a capital income tax often recommend its replacement by a cash flow tax. It is therefore important to note that the cash flow tax taxes windfall gains in exactly the same manner as a capital gains tax.

A cash flow tax differs from an income tax in that it allows the full amount invested in an asset to be immediately expensed for tax purposes. Subsequent cash flows derived from the asset are taxed as they accrue, but asset depreciation is not tax deductible and asset appreciation is not taxable. On the other hand, the full receipts realised on the disposal of an asset are assessable.

A cash flow tax differs from an income tax in that it drives no wedge between pre- and post tax rates of return. To confirm this, consider the earlier example of a perpetuity. The cash flow tax reduces the cash flow of this asset from \$10 pre-tax to \$7.50 post-tax. On the other hand, because the \$100 investment in the asset can be expensed, it reduces the investor's current tax liability by \$25

so that the net outlay needed to acquire the asset is only \$75. Whereas assets are purchased out of post-tax income under an income tax, under a cash flow tax they are effectively purchased out of pre-tax income. As a result, the post-tax rate return on the asset under a cash flow tax ( $\$7.50/\$75$ , or 10%) is the same as the pre-tax rate of return.

While the present value of the post-tax cash flow of \$7.50 at the (pre- and post-tax) interest rate of 10% is only \$75, all investors will value the asset at \$100, since the full deductibility of the purchase price means that the present value of the post-tax cash flows must be grossed-up by the reciprocal of one minus the tax rate to arrive at the price that investors would be willing to pay for the asset. An investor subject to a 33% tax rate would have a net of tax cash flow of \$6.70 per annum. When the \$67 present value of this cash flow is grossed up to allow for the \$33 tax saving resulting from the deductibility of the purchase price, a market valuation of \$100 is again the result. As with the income tax, asset valuations under the cash flow tax are therefore independent of investors' marginal tax rates.

Because the cash flow tax gives the buyer of the perpetuity an immediate deduction of \$100 for its purchase price, the Government currently forgoes \$25 of tax revenue on this account. On the other hand, the Government collects tax at the rate of \$2.50 per period from the cash flow stream of the asset. At the assumed interest rate of 10%, the flow of future tax collections has a present value of \$25. Since the present value of the future tax collections is the same as the tax currently forgone, net tax revenue is zero. The very different implications of the income tax and the cash flow tax for tax revenue is a reflection of the fact that the cash flow tax does not tax expected income, does not drive gross and net rates of return apart and thus raises no net tax revenue from the expected income stream of an asset.

If, however, there is a revision of expectations, a cash flow tax will collect (or lose) an amount of (lump-sum) tax revenue exactly equal, in present value terms, to that raised (or lost) by the taxation of capital gains under a comprehensive income tax levied at the same rate in the same circumstances.

To return to the earlier example, imagine that the expected cash flow stream of the perpetuity rises from \$10 to \$20 per annum. The cash flow tax will then raise an additional \$2.50 per period. The present value of that additional tax revenue will be \$25, exactly the sum raised by the capital gains tax in the same circumstances. Similarly, the impact of the taxation of the capital gains and the cash flow tax on the holder of the asset will also be exactly the same. Under the income tax, the market price of the asset rises by \$100, leaving the holder with a gain of \$75 after meeting the tax liability of \$25. Under the cash flow tax, on the other hand, the present value of the post-tax cash flows rises to \$150, which is also \$75 greater than their present value prior to the revision

of expectations. Should the holder of the asset dispose of it after the revision of expectations, the sale will realise \$200 (i.e. \$150 grossed up by the reciprocal of one minus the tax rate) and this entire sum will be assessable, leaving the asset holder with \$150 - that is, with a gain of \$75 on the original \$75 net investment in the asset.

Those who oppose the manner in which the taxation of capital gains treats windfall gains must recognise that the cash flow tax, which they often recommend as an alternative to the income tax, treats windfalls such as that discussed above in exactly the same manner.

### 11.3.5 Summary

To summarise the conclusions of this section, the removal of capital income exemptions does not involve inappropriate double taxation of capital gains and future cash flows when applied to systematic capital gains on maturing assets. To the extent that the systematic capital appreciation on such assets is taxed as it accrues, terminating cash flows are received tax free. In such cases, the removal of the exemptions would assist in aligning the tax treatment of maturing assets with the tax treatment of assets which generate income entirely on revenue account. The only element of double taxation resulting from the removal of the exemptions is that inherent in an income tax and results from the fact that, under such a tax, assets must be acquired out of post-tax income.

So far as the taxation of goodwill gains is concerned, the removal of the capital income exemptions would have the effect of taxing the goodwill gain as well as the future cash flows on revenue account that are capitalised by that gain. Properly understood, this double taxation simply ensures that goodwill investments are made out of post-tax rather than pre-tax income. This is an advantage, not a defect of the removal of the exemptions, since when goodwill gains are exempt, goodwill investments would be inefficiently encouraged relative to other investments which must be acquired out of post-tax income.

The removal of the exemptions would subject windfall gains to tax. Because of the unexpected nature of windfall gains, a tax on them has the character of lump-sum pure profits tax. While there is no efficiency case for taxing such gains, there is also no efficiency case for exempting them. Moreover, the cash flow tax often favoured by opponents of capital gains taxation would impose exactly the same lump-sum tax on windfall gains as does a comprehensive income tax. In relation to the windfall gains and losses considered above, the cash flow tax has the same consequences for taxpayer wealth and thus the same equity implications as an income tax in which the present exemptions have been removed.



## 11.4 Effect on Savings and Investment

A third criticism advanced against the removal of the present exemptions is that this would discourage savings and investment. Saving is the difference between income and current consumption. Investment is expenditure that increases the stock of capital assets. Investment can be financed by private domestic saving, by government saving (if the government runs a budget surplus) or by borrowing from abroad.

Income from ownership of real and financial assets (i.e., income from capital) is part of total income. The taxation of income from capital is therefore an inherent feature of an income tax system. To the extent that private saving is responsive to post-tax returns, an income tax may discourage saving compared with the levels that would exist in the absence of an income tax. A decline in private savings may also raise the cost of capital to users of capital services and thereby discourage investment. Household savings are also affected by factors other than the available post-tax return, such as income level, life cycle factors and government policies.

The general effect of an income tax on the level of savings is, however, not the issue here. Indeed, the overall effect of the reforms outlined in this Document on the level of savings may well be positive, since the reforms would mean that, while the tax on some types of income from capital would increase, the tax on other forms of income from capital would decrease. The real issue is whether the taxation of a particular form of income would discourage savings and investment.

The aggregate rates of saving and investment in the economy, as a proportion of income, depend on a complex interaction of factors, including the Government's monetary and fiscal policy. The saving rate of households depends on many factors, of which the expected rate of return available is only one. Levels of investment are also influenced by the difference between expected rates of return on different assets and the cost of capital (i.e., the return that must be paid to savers).

To illustrate the effect on saving of the removal of an exemption, assume that initially there are only two types of assets in the economy - fully taxed assets and exempt assets. Assume also that there are no foreign capital movements - that is, domestic savings are the only source of funds for capital investment. In order to focus on the effect of taxation, ignore risk for the moment. Assume that the expected pre-tax rate of return on the fully taxed assets is 10% per annum and that there is a uniform tax rate of 30%. The expected post-tax rate of return on these assets is therefore 7%. Suppose that the expected rate of return (pre- or post-tax since, by assumption, they are the same) on the exempt asset is initially 10% per annum. Since the whole of the return on these assets is exempt, investors would clearly prefer to hold the exempt asset - it is

expected to return 10% after tax compared with only 7% on the fully taxed assets. Everyone would want to sell the fully taxed assets and buy the exempt assets. This would obviously change the price of the assets. The price of the fully taxed assets would fall and that of the exempt assets would rise to a point where the expected post-tax returns on both types of assets is once again the same. For example, the expected post-tax rate of return on both might settle at, say, 8% per annum. Once this point (which is referred to as an equilibrium) is reached, there would be no advantage in savers in holding the exempt assets - they would be expected to return after tax no more than the fully taxed assets.

These tax changes would, however, cause the value of the exempt assets to rise above their replacement costs. This in turn would induce a change in investment patterns. Investment in the fully taxed assets would decline and investment in the exempt assets would increase. This process would continue until the value of exempt and fully taxed assets is equivalent to their replacement costs. If the post-tax return on both types of assets is 8% and a tax rate of 33% is assumed, the pre-tax rate of return on the taxed assets would be 11.7% and 8% on the exempt assets. The lower pre-tax return on the exempt assets indicates that over investment has occurred in those assets.

The exemption of the return on the exempt assets has an effect on aggregate saving that is equivalent to an overall cut in the rate of tax on capital income (unless the revenue loss is made up by a greater tax burden on fully taxed assets). The exemption of income from particular assets is, however, less efficient than an across-the-board reduction in tax rates on income from capital since it distorts the relative costs of capital and investment patterns. In particular, high-return investment in the fully taxed assets is displaced by lower-return investment in the exempt assets.

Now assume that income produced by the exempt assets is made fully taxable but the tax rate on all income is reduced so that the tax change is revenue neutral. The price of the (previously) exempt assets would immediately fall (and that of the fully taxed assets would rise). This process would continue until a new equilibrium is reached, at which point the expected rate of return on the two types of assets would again be equal. Once again, the pattern of investment would be affected since resources would flow from previously exempt assets to assets that were previously fully taxed. That is, investment in the previously exempt assets would decline and that in the fully taxed assets would increase. Thus, irrespective of the tax treatment of the two classes of assets, asset prices and investment would adjust so that the expected rate of return on the two types of assets would be the same. It is important to note that the aggregate level of investment would not necessarily be affected, since this depends more on the overall tax burden on income from capital.

The above results can be generalised to any number of assets with various degrees of riskiness. In general, the expected, risk-adjusted rate of return on all assets in the economy must be approximately the same. Realised returns, as distinct from expected returns, may differ because of unanticipated factors, but this is not, in general, relevant to saving or investment decisions. To the extent that saving and investment decisions are influenced by after-tax returns, it is **expected** rather than **realised** returns that are important.

As illustrated in Chapter 2, the returns on many forms of saving and investment (such as interest, dividends and other revenue receipts) are already fully taxed. For example, interest income is fully taxed - on an accrual basis for many taxpayers and, for others, when it is received. Yet many people save to earn interest income. Indeed, a large part of household savings are in the form of interest-bearing deposits and like instruments.

In summary, the exemption of certain forms of income cannot be regarded as a sensible way to encourage saving and investment. An exemption will change asset prices and channel additional investment towards the exempt area until the expected rate of return, adjusted for risk, on the exempt assets is the same as that applying elsewhere in the economy. The removal of the present exemptions would have an impact on asset prices and hence the pattern of investment. Provided that the reforms to the taxation of income from capital, including the removal of exemptions, results in no overall increase in tax revenue, the reforms should have no adverse effect on the level of saving or investment, nor on post-tax rates of return generally.

The effect of the removal of exemptions on saving and investment is discussed in more detail in Appendix 1.

## 11.5 General Conclusions on Removal of Exemptions

### 11.5.1 Overview

For the reasons outlined above and in Chapter 3, there is no sound rationale for maintaining the exemptions. The first step in the reform process would be to bring all forms of income, gains or profits currently treated as income on capital account, including "capital gain", within the income tax system.

In the light of the conclusions in Part II, income or losses derived on the disposal of assets should be indexed for inflation. The method of indexing such income or losses was discussed in Chapter 5.

Under the present timing rules, where disposal of property gives rise to assessable income, the income is, in most cases, derived in the year of disposal. The first major policy issue is whether or not these timing rules are appropriate and, in particular, whether recognition of income as it accrues, rather than when it is realised, is feasible and desirable.

A second major issue is whether there are good grounds for continuing to exempt certain types of income. Thus, all forms of currently exempt income on capital account would become taxable unless it were decided that particular forms should remain exempt.

### 11.5.2 Timing of Recognition

The removal of the present exemptions would improve economic efficiency by reducing the tax incentive to invest in assets that are expected to produce untaxed income. It would also improve the equity of the tax system, especially since income from capital is concentrated amongst higher income groups. In addition, there would be significant administrative advantages resulting from a reduction in the tax avoidance and administrative difficulties associated with the present arbitrary distinction between taxed and untaxed income.

The present income tax is not, however, a cash flow tax. It has moved progressively over many years towards an accrual system (i.e., one in which income and expenditure are recognised in the year they accrue, rather than the year of receipt or payment). This has been necessary, not because of any theoretical ideal, but because of concrete, pragmatic, economic and financial considerations. The accrual rules applying to financial arrangements were necessary to curtail widespread tax avoidance by both companies and individuals that resulted in a substantial loss of tax revenue. A similar objective lies behind the controlled foreign company, foreign investment fund and trust regimes. The dividend withholding payment regime brings forward the taxation of foreign-source dividends that are eventually derived by resident individual taxpayers but that are received in the first instance by resident companies. All of these rules bring to account on an accrual basis income that was previously taxed, if at all, only on receipt.

There are two main problems with taxing income only on realisation. First, taxpayers would continue to be induced for tax reasons to invest in assets that appreciate in value rather than assets that produce returns in the form of annual cash flows, although this tendency would be less marked than under the current regime, under which some forms of income escape tax entirely. By contrast, the taxation of income on an accrual basis would result in a greater uniformity of tax burdens (i.e., effective tax rates) across different assets.

Secondly, taxpayers would continue to be encouraged to defer disposing of property since a disposal crystallises a tax liability. This is referred to as a "lock-in" effect. The extent of lock in would depend on the ratio of the tax liability to the sale proceeds. The higher the ratio, the greater the lock in. As a result, the taxation of some forms income only on disposal would extend an existing source of efficiency loss to a new class of income.

The difficulties caused by these problems would be reduced if real rather than nominal profits derived on sale were taxable. The difficulties would be reduced

further to the extent that income can be taxed on an accrual basis. Accrual taxation does, however, raise a number of serious administrative and compliance issues. The accrual/realisation orientation of the reforms therefore involves a judgement about the optimal trade off between the objective of promoting a more neutral tax system and of reducing lock-in effects on the one hand, and the objectives of minimising administrative and compliance costs on the other. This trade off and its implications for the timing of recognition of income from capital are explored further in Chapter 12.

### **11.5.3 Personal Assets**

Chapter 3 described currently exempt forms of income that should, in principle, be subject to tax. The key issue is whether income derived on the disposal of personal assets such as residences should be taxed or remain exempt. As with the timing of recognition, the issue is not clear-cut but depends on practical considerations. This issue is discussed in Chapter 13.

## **11.6 Conclusion**

The present exemptions of certain forms of income from capital are sometimes defended on the basis that they are not income but are "capital". There is, however, a clear distinction between income and capital. A profit or gain derived on the disposal of property is income derived from capital, just as interest or dividends are income.

The exemptions are also defended on the grounds that the taxation of capital gains would result in the double taxation of income. An element of double taxation is inherent in an income tax since investment should be acquired out of after-tax income and the income then generated is itself taxed. Beyond this, no inappropriate double taxation would result from removal of the present exemptions.

Similar misconceptions are advanced about the impact on saving and investment of taxing currently exempt forms of capital income. An income tax may discourage saving by reducing the return derived by the saver. A fall in domestic private saving could raise interest rates and thereby reduce investment, if it is not offset by additional Government savings or capital inflows from overseas. Short of abolishing income tax as a major component of the revenue system, such effects are unavoidable.

The removal of exemptions by itself has similar effects on total saving as an increase in the tax rate on income from capital. Any effect on saving could be mitigated by lowering tax rates. The revenue costs of the indexation reforms outlined in this document are estimated to approximately equal the effects of widening the tax base through the removal of exemptions. In view of this, the net effect of the reforms outlined in this Document on levels saving and investment are, while not clear cut, unlikely to be negative.

Finally, it should be noted that the retention of exemptions for specific forms of income lowers national income by encouraging tax-motivated investment in areas that yield lower pre-tax returns than investments that yield currently taxed income. For any given level of revenue, the retention of exemptions makes such distortions worse by necessitating higher tax rates on currently taxed income than would be necessary under a more neutral income tax system.

The conclusions of previous tax reform bodies in New Zealand that have commented on the exemption of income in the form of capital gains are shown in Appendix 2.

# CHAPTER 12: TIMING OF RECOGNITION

## 12.1 Introduction

As noted in Chapter 11, the effect of removing an exemption for a certain form of capital income is to bring that income to account under the normal timing rules that apply at present. An additional consideration is whether these timing rules are necessarily appropriate. This is the subject of this chapter.

## 12.2 Implications of the Efficiency Objective

### 12.2.1 Neutrality

The major objective of removing exemptions is to achieve greater neutrality of tax treatments across different assets. As noted in Chapter 1, the tax system would be neutral with respect to investment in different assets if the effective tax rate applying to income generated by any asset is the same for all assets.

The exemption of certain forms of capital income obviously conflicts with neutrality. Assets that generate returns in the form of exempt income are favoured relative to those that produce taxable income. Hence, investment in the former is favoured over the latter. In order to achieve neutrality, all income that is realised or that could be realised would need to be taxed when it accrues - it is not sufficient to tax only realised income.

In practice, the extent to which accrued income can be realised will depend on factors such as transaction costs, risk and the perceived permanence of the income. For example, because it is time consuming, personally disruptive and relatively costly to sell assets, a farmer would face prohibitively high transaction costs in order to realise accrued increases in the value of his or her farm by periodically selling it. Similarly, the risk associated with increased levels of debt would constrain the extent to which such accrued income could be realised by borrowing against the increased land value, particularly if there is a risk that the increased value will not be maintained in the long term. Conversely, where transaction costs of selling part of the asset are relatively low, accrued gains are more readily realised.

### 12.2.2 Lock-In Effects

One of the conditions necessary for an efficient and productive economy is that assets should be able to be transferred to the persons who value them most highly. For example, if a machine can be used more productively by one business rather than another, society as a whole will be better off (i.e., more national income will be generated) if the machine is used by the former. This does not necessarily require that the ownership of the asset should change. Contractual arrangements, such as leases, may be feasible whereby the use but

not the ownership of an asset can be transferred.

The taxation of certain forms of income only when it is realised conflicts to some extent with efficiency because it gives rise to so-called "lock-in". Lock-in occurs because the sale of an asset crystallises a tax liability that could otherwise be deferred by retaining ownership of the asset. In many cases, however, tax considerations will be overwhelmed by other factors. The efficiency costs of lock-in arise when tax considerations inhibit transactions that would otherwise take place, or influence the way in which those transactions are structured.

While it is impossible to precisely quantify the efficiency costs of lock-in, any factor that inhibits efficient resource allocation is likely to have significant economic costs. An important objective of tax reform is to minimise such costs. This is the major advantage of an accrual system, where income is calculated on the basis of changes in the market values of assets. Even under this system, however, lock-in could occur if the updated book value of an asset diverged significantly from its sale value.

Further discussion of the lock-in effect of an income tax system is contained in Appendix 3.

### **12.3 Administration**

An accrual-based system would require the IRD to administer a system in which taxpayers' income tax liabilities would depend in part on changes in the estimated market values of their assets. As at present, the Department would rely heavily on information supplied by taxpayers. Effective tax administration does not, however, depend on exhaustive audit and verification of this information. Instead, it involves the setting of penalties for supplying incorrect information (or other forms of evasion) and selective audits of a small percentage of taxpayers. This system will be effective if taxpayers expect that they may be audited, that the audit system is effective in detecting evasion and that the system of resulting penalties is appropriate.

The probability of detection, and hence the effectiveness of an audit, will in turn depend on the information available to the Inland Revenue Department to corroborate the information supplied on the taxpayer's tax return. There are essentially two sources of such information: the taxpayer and other parties. For example, employer information is available to verify wage and salary income. Similarly, the information available to the Department on interest and dividend income has been enhanced by the resident withholding tax system.

Where valuations are required for tax purposes, a taxpayer's records might include the original cost of the assets, the cost of any capital improvements to them and either a valuation report or other documentary evidence of the way in which the taxpayer has estimated asset values. In addition, third party



information would be available where identical or similar assets were frequently traded (such as may be the case with listed shares, most motor vehicles, land and buildings).

Where third party information is not available, the valuation of any asset will to a greater or lesser extent be subjective. The valuation of an asset depends essentially on forecasts of the future cash flows that the asset will generate. As a result, there will usually be no single value that can be said to be "the" market value of an asset. Instead, there will be a range of values depending on the type of asset and the assumptions used. For example, valuations of private company shares can easily differ by a magnitude of 300-500% or more. Wide variations in estimates of market value can also be obtained in respect of plant and equipment, mining properties and intangible assets such as patent rights and insurance contracts.

This ambiguity in asset values would have a number of consequences for the administration of an accrual system. First, auditing would be relatively expensive because of the costs of valuations. Secondly, the cost of resolving disputes would be high because of the information costs and subjectivity associated with asset valuations. Thirdly, the Department's and the courts' ability to impose penalties for apparent under-valuations would be heavily constrained because of the wide range of values that could legitimately be assigned to "hard-to-value" assets such as private company shares. Thus, under-valuations would be difficult both to detect and to penalise.

In these circumstances, the normal audit/penalty mechanism for encouraging general compliance is unlikely to be effective. Hence, there is a significant prospect that an accrual system would in practice result in widespread undervaluation of hard-to-value assets. In addition, accrued losses would tend to be exaggerated. The end result would be that accrued income would tend to be conservatively valued while accrued losses would be fully deductible.

An asymmetric system such as this would obviously not be neutral with respect to investment decisions. Instead, it would tend to bias investment towards riskier projects by advancing the deductibility of losses compared with the recognition of income. Similarly, an accrual system would bias investment towards assets that are difficult to value and, to the extent that taxpayers are able to reduce the reported values of these assets below their original cost, it would result in greater lock-in than under a realisations-based system. The efficiency gains (and the revenue derived) could therefore conceivably be less than would be the case under a realisations-based approach.

One possible response to this problem would be to attempt to constrain the discretionary nature of valuations of hard-to-value assets through statutory or administrative rules. For example, an appreciation schedule, akin to the present depreciation schedule, could apply to appreciating assets. Similarly, simplified valuation rules (e.g., based on price-earnings ratios or book values)

could apply to private company shares. This is akin to the approach adopted in Switzerland for wealth tax purposes. Standardised rules would, however, invariably produce obviously incorrect values in at least some cases and hence in practice would have to be relaxed by permitting taxpayers the option of adopting market values. This would reintroduce the problems associated with a market value system when employed for hard-to-value assets and allow taxpayers to choose the lowest of the values produced by the alternative rules.

Another approach would be to decrease the frequency of the valuations required to, say, every 5-10 years. This would not, however, address the fundamental problem of the discretionary nature of valuations of hard-to-value assets. Though IRD would have fewer valuations to audit, the proportion of returns audited would inevitably remain small. There would still be insufficient incentive for taxpayers to report their best estimates of the market values of their assets.

A third approach would be to adopt a partial accrual system. Under this system, assets that are relatively easy to value, such as publicly-traded shares and land and buildings, would be subject to periodic valuations. Changes in the value of other assets would be taxed only on realisation. While this approach would introduce some efficiency costs (e.g., as a result of the divergence of treatment between publicly-traded and private company shares), other efficiency costs (i.e., those arising from the current disparity of treatment of publicly-traded shares and financial arrangements, and the efficiency costs associated with lock-in) would be reduced. While the net effect on economic efficiency could not be quantified, it could reasonably be expected to be positive.

In summary, any system that requires taxpayers to estimate the market values of assets that are difficult to value, such as private company shares, would raise serious administrative problems.

## **12.4 Compliance**

The removal of existing exemptions would impose compliance costs on taxpayers associated with record-keeping and asset valuations. In addition, the taxation of income on an accrual basis would have adverse cash-flow effects for taxpayers.

### **12.4.1 Record-Keeping**

When income is brought within the tax system, taxpayers must begin to keep the records necessary to calculate the amount of such income that they derive. In order to compute income derived on the disposal of an asset, information needs to be kept on the original cost of the asset and the cost of any capital improvements to it. Under an accrual-based system, taxpayers would need to record the estimated market value of the relevant assets on their balance

dates. A realisation approach also requires rules, such as those which currently apply to trading stock, to enable taxpayers to determine the cost of assets sold where some of a number of identical assets are sold.

Business taxpayers are already required to keep much more extensive records than are non-business taxpayers and, in general, are able to cope with the compliance requirements of the tax system more readily than non-business taxpayers.

#### 12.4.2 Valuations

One of the major arguments advanced against an accrual-based approach is that the compliance costs of regular valuations would be excessive where market values of comparable assets are not available. The cost of a valuation relates primarily to the cost of obtaining the necessary information, such as information on which to base forecasts of future revenues and operating costs. In some cases, taxpayers are well-informed about the operating costs of their assets, production technologies, demand and price trends, etc. In other cases, however, information costs may be excessive. Nevertheless, once sources of information and a data base have been established, the costs of periodically updating estimated values should be considerably less than the cost of one-off valuations.

As noted in the previous section, in many cases the valuation of an asset will be subjective. Hence, a range of values will be obtained. This does not necessarily affect the compliance costs of valuations. It would, however, increase the costs of resolving disputes between taxpayers and IRD. More importantly, taxpayers would have considerable discretion over the values they assign to some assets.

Where the information necessary to value an asset is costly to obtain, compliance costs could be reduced by extending the period between valuations. Where, however, a taxpayer does not have access to the relevant information, reducing the periodicity of valuations may be of little assistance. Thus, a range of valuation approaches might be needed. For example:

- classes of assets for which market values are readily available, such as land, buildings, and motor vehicles, should be relatively easy to value. Land and buildings are already valued every three years for the purposes of levying land tax and local authority rates. In addition, indices of land and building prices are published regularly by Valuation New Zealand. Thus, two approaches to computing accrued changes in the value of land and buildings would be to have triennial valuations at the values determined by the Valuation New Zealand, or to have annual valuations based on the indices published by Valuation New Zealand;

- fixed assets that are traded infrequently will be more costly to value. The largest category of such assets are depreciable assets. In an economic sense, depreciation is an allowance for the decline in the value of an asset as a result of wear and tear and technological change. Because of the cost of estimating actual market values, values are usually imputed from a schedule of tax depreciation rates. A comparable system of appreciation rates could apply to certain types of assets the values of which are expected to increase in real terms;
- shares in private companies are usually cited as an example of a class of assets that are difficult to value. Where a taxpayer (such as a majority shareholder) has access to the relevant information, unlisted shares should not be difficult to value using one or more of the commercially-acceptable valuation methods. Compliance difficulties would, however, arise where a shareholder does not have access to detailed information about a company. Alternatively, the company itself, where it is resident, could be required to calculate and notify its shareholders of the estimated market value of its shares. A further variant would be for the Inland Revenue Department to publish values of companies, as happens in Switzerland.

In summary, the compliance costs of valuations vary with the type of asset. This could be reflected in the valuation rules adopted but, under any system, taxpayers would have considerable scope to adopt favourable values for classes of assets in respect of which market values are not readily observable.

### 12.4.3 Cash-Flow Implications

An accrual system can have adverse cash-flow implications for taxpayers because income is taxed before it is realised. Before considering this issue in more detail, a number of general observations can be made:

- the present income tax is not a cash flow tax. It contains many elements of accrual accounting (e.g., the treatment of depreciation, financial arrangements and bad debts; the taxation of income on a receivable basis; the allowance of trading stock write downs; the controlled foreign company, trust and foreign investment fund regimes);
- the tax regime does not and could not waive a tax liability because a taxpayer does not have the cash to pay it. There will often be no relationship between a taxpayer's cash resources and his or her tax payments. Exceptional cases can be dealt with under the present hardship provisions;
- taxpayers will frequently be able to sell part of their asset holdings to pay tax. They should not be relieved of their obligation to pay tax merely because they choose not to realise assets;

- within limits, taxpayers can borrow to pay tax, with borrowings secured against the increased asset value;
- to the extent that accrued income is not taxed, tax rates have to be higher to raise the same amount of revenue; and
- the concessional treatment of accrued income benefits one group of taxpayers, generally those on higher income, at the expense of others.

The economic costs of the cash-flow impact of an accrual system relate largely to the additional resources taxpayers would need to devote to cash-flow and risk management. Where cash resources are not available to pay tax, a taxpayer has to either sell assets or borrow. In either case, additional transaction costs are incurred. As debt levels increase as a proportion of total assets, the risk of bankruptcy also increases. This risk would be heightened under an accrual system, particularly when asset values fluctuate significantly. For example, when asset values rise, a business might borrow to meet its tax liability on the resulting accrued income, with the borrowing secured against the appreciated assets. If, however, asset values then fall unexpectedly such that the lender no longer has the required level of security, a requirement to repay the loan might in some cases force the taxpayer into bankruptcy or liquidation. On the other hand, the ability to deduct losses as they accrue may in some cases improve a taxpayer's cash position by reducing his or her tax liability.

## 12.5 Accrual-Equivalent Tax

One response to the valuation and cash-flow problems with an accrual system that seeks to avoid lock-in effects is to recognise income when it is realised but to compute the resulting tax liability in such a way that the advantage of deferral is largely offset. This has been termed the "accrual-equivalent" method.

Under this approach, the realised rate of return on an asset is computed in the year it is sold. The income that would have accrued at that rate in each year the asset has been held is then computed. The resulting tax liability in each year is calculated and carried forward to the year of sale at an appropriate interest rate. Thus, income is recognised only in the year of sale, but the tax payable is computed as if the income had been recognised over the period in which the asset has been held.

The major problem with this approach is that the value of an asset on realisation can be deflated in a variety of ways. For example, a taxpayer with 100% of the shares in a company could cause a dividend to be paid prior to selling the company. This would reduce the value of the company on sale by approximately the amount of the dividend. Though such dividends might be

taxable, the realised rate of return on the asset would be reduced and thus the interest on the deferred tax that would otherwise have been payable would be reduced or avoided. Anti-avoidance rules could address this type of problem to some extent. Nevertheless, for some types of assets there is such a variety of ways of extracting income before sale (e.g., by way of excessive salaries, management expenses or loans) that an accrual-equivalent method on its own does not appear to be a workable option.

## 12.6 Loss Ring-fencing

As mentioned previously, the recognition of income on realisation gives taxpayers an incentive to defer recognition. This is not a problem when an asset has fallen in value to such an extent that its sale produces a loss. Indeed, there is an incentive to realise losses in order to shelter taxable income. In the absence of limitations on the deductibility of capital losses, taxpayers with other assessable income could therefore eliminate or reduce their overall tax liability by, for example, investing in a diversified portfolio (where the individual asset returns are variable but the overall portfolio return is generally positive) and realising losses in advance of profits.

To reduce the scope for this type of avoidance under a realisation-based regime, it is likely to be necessary to allow losses prone to this sort of behaviour to be deductible only against corresponding forms of income. Any excess loss unable to be deducted in the year in which it is incurred would be carried forward and offset against the specified forms of income. Income earned in the specified form could however be offset against ordinary losses.

The opportunity and incentive to realise losses and defer income is greatest when taxpayers have considerable flexibility over the timing of sales (i.e., where the net return from holding an asset approximates that obtainable from selling it and reinvesting the sale proceeds in an alternative asset) and when the present value of the tax savings obtained by holding or disposing of an asset are relatively large.

Thus, a business has little incentive or flexibility to defer sales of its trading stock because selling stock generates the profits of the business. Similarly, a business will usually have little incentive to advance the realisation of losses on property used in the business (e.g., depreciable plant and machinery or real property such as a farm used in a farming business) because the property is used to produce the income of the business. The transaction costs and disruption to the business would normally outweigh any tax benefits from early realisation.

Similar arguments apply to certain intangible property such as patents and copyrights. This property is normally created to produce income that would not be realised if the property were not sold or licensed.

Such arguments also generally apply to investment in financial arrangements. Income or losses derived or incurred in respect of such arrangements are taxed on an accrual basis, except to the extent that they are attributable to unanticipated changes, such as unanticipated changes in market interest rates.

In contrast, there is usually greater flexibility to decide if and when to realise most other investments, while the tax consequences of the timing variations may be significant.

The above considerations suggest that, should loss ringfencing be necessary, it should not apply to dispositions of:

- trading stock;
- depreciable or real property used in a business;
- certain intangible property, such as patents and copyrights; and
- financial arrangements.

## **12.7 Conclusion**

As noted in Chapter 11, it has been found necessary to adopt various forms of accrual treatment of major types of capital income. Nevertheless, a general accrual-based approach to recognising previously untaxed income on capital account does not appear to be practicable, primarily because it could not be administered effectively at this stage. However, the continued investigation of accrual treatments for income on capital account is desirable in view of the lock-in effects of realisation-based recognition rules.





# CHAPTER 13: PERSONAL ASSETS

## 13.1 Introduction

Chapter 11 concluded that the present exemptions of certain forms of income from capital should be removed except where it is concluded that a particular exemption should be retained. This chapter considers the extent to which it is in the community's interest to remove the current exemptions accorded to income realised on the sale of personal (i.e., non-business) assets, such as personal-use houses (i.e., principally owner-occupied houses but also holiday homes etc.), jewellery, artworks, and private cars. This is one of the most important issues to be resolved in deciding the scope of the reforms.

## 13.2 Distinction Between Personal Assets and Other Assets

Some assets produce assessable income while other assets produce private and domestic benefits. The latter category of assets will be referred to as "personal assets". That is, personal assets are assets held by individuals outside of any business or investment activity.

While the distinction between personal assets and other assets is useful for descriptive purposes, it is largely artificial. In economic terms, there is no difference between personal assets and other assets. Both yield a stream of current services (i.e., monetary or non-monetary income), both can yield capital appreciation, and costs are incurred in financing, operating and maintaining both types of assets.

Personal assets such as houses and cars provide their owners with income in a non-monetary form. In contrast, other assets produce income that is largely in monetary form. The market value of the non-monetary services derived from personal assets is generally referred to as "imputed" rental income. As discussed in Chapter 3, the imputed rental income produced by an asset such as a house is the amount that the owner of the house would need to charge if it were rented out in order to recover all costs plus a normal profit on the investment. Equivalently, it is the amount that the person would pay in rent if he or she rented the house. Though such income is referred to as "imputed" income in that it is not actually received, it is concrete in the sense that the home owner's disposable income after tax is increased by the amount of rent that he or she would otherwise pay.

Imputed rental income is a significant part of aggregate income. The Government Statistician included some \$2.9 billion of imputed rental income from owner-occupied dwellings in his estimates of gross domestic product in 1986/87.

Similar types of non-monetary or imputed income are produced by other personal assets such as motor cars and durable household goods. For example, the imputed rental income derived from owning, say, a television is the rent that the owner would otherwise pay to rent the television. Once again, it is irrelevant that the rental income is not actually received - the effect on the owner's post-tax income is the same. Thus, there is no substantive economic distinction between monetary income and income derived in a non-monetary form. This principle lies behind the 1978 enactment of section 65(2)(ja) discussed in Chapter 2 and the taxation of fringe benefits.

Nevertheless, the tax treatment of income from personal assets and income from other assets differs considerably. Much of the income derived from the ownership of other assets is already subject to tax. In some cases (e.g., debt instruments), the income is taxed on an accrual basis.

In contrast, most of the non-monetary income derived from the ownership of personal assets is not included in the income tax base. Similarly, most expenses incurred in the derivation of non-monetary income are non-deductible. This treatment of personal assets and its implications are discussed further below.

### **13.3 Current Treatment of Personal Assets**

While the imputed income generated by personal assets is not taxed, taxpayers are currently not able to deduct operating, maintenance, depreciation and interest costs incurred in relation to deriving such income. As discussed further in section 13.4.3, these types of expenditure are currently non-deductible under section 106(1)(j) of the Act because they are incurred for private or domestic purposes. While this lack of deductibility offsets to some extent the non-taxation of the imputed income produced by personal assets, it is an imperfect solution and in some cases introduces additional difficulties.

First, the non-deductibility provisions cannot be strictly enforced because there is ambiguity about how some costs should be allocated. Costs that might properly be attributable to personal consumption are frequently deducted as business expenses in cases where a taxpayer has an opportunity to use the asset both in his or her business and at home.

Interest costs are particularly difficult to allocate. Interest on consumer credit and on loans raised to buy personal residences, cars and other household durables is not deductible under the Income Tax Act to the extent that the interest is private or domestic expenditure. This does not, however, prevent taxpayers from arranging their affairs so that amounts borrowed are attributed to business purposes and money that the taxpayer already has is used to purchase personal assets.

Thus, the non-deductibility of the costs of holding personal assets is only partially effective and is uneven in its results. Many wage and salary earners have little scope for shifting borrowings or other expenses between business and personal purposes. Taxpayers with diverse sources of wealth and those who own their own businesses have a much greater opportunity to do so.

Secondly, while the non-deductibility of the costs of holding personal assets can in some cases reduce the tax bias in favour of such assets, in other cases the non-deductibility of costs enhances the bias. For example, for taxpayers who must rely heavily on debt finance to purchase a house, the non-deductibility of interest expense largely offsets the tax benefits of the exclusion of imputed income. On the other hand, the non-deductibility of holding costs has little effect on those people who can borrow for business purposes or finance the purchase of a house or other personal assets by drawing down other sources of wealth.

The equity effects of non-deductibility of costs relating to personal assets are similarly mixed. For example, if two taxpayers have the same interest costs and the same pre-tax economic income, but taxpayer A holds only business assets and taxpayer B only personal assets, B will pay less tax than A because the gross imputed rental income from personal assets is not taxed. The denial of deductibility on personal assets reduces the inequity between the two by lowering the net tax benefit to B.

On the other hand, if both A and B have the same value house and equal amounts of money income but A's house is 100 percent equity financed and B's house is 80 percent debt financed, then A has a higher economic income than B. They both pay the same tax, however, because B is not allowed to deduct interest paid in relation to loans raised to finance the purchase of the house. In this case, the denial of an interest deductibility creates an inequity between the two taxpayers because A gains the full benefit of the exclusion of imputed rent, but B gains only a partial benefit.

Be that as it may, to the extent that the non-deductibility of private and domestic expenditure is effective, the bias created by the exemption of imputed rental income is reduced.

### **13.4 Effect of Exempting Income Realised on the Sale of Personal Assets**

Continuing the exemption of income realised on the sale or other disposal of personal assets while removing it for other income would tend to accentuate the existing tax-induced bias in favour of investment in housing and other personal assets (e.g. artworks, jewellery) that could reasonably be expected to appreciate in value in real terms over time. This would encourage an even greater shift in investment towards these assets. The extent of the shift would depend on:

- the extent to which an individual considers that his or her house and other exempt personal assets will appreciate in value in real terms over time;
- the extent to which individuals perceive personal assets to be substitutable forms of investment for other assets yielding taxable income (e.g. business assets, debt instruments). The greater the degree of substitutability, the greater the investment bias; and
- how income produced by those alternative investments is taxed.

Given that personal assets comprise a substantial proportion of New Zealand's total capital stock, the efficiency costs arising from the continued exemption of real income realised on the sale of personal assets could significantly reduce the benefits to be derived from the reform of the present treatment of income from capital.

In addition, the exemption would be reflected in higher prices for the exempt assets. For example, if houses were exempt, house prices would initially rise since housing would be a relatively more attractive investment than assets that produce taxable income. Commentators in Australia have attributed a substantial part of the recent property boom there to the exemption of residences from the Australian capital gains tax.

The exemption of personal assets would also conflict with the equity objectives of the reforms. Individuals with relatively high levels of wealth and investment in dwellings would benefit most from such an exemption, since they have the resources to undertake further investment in housing. Such taxpayers are also typically higher-income individuals. The continued exemption of income realised on the sale of personal assets would therefore be regressive.

The implications for economic efficiency of taxing income realised on the sale of particular personal assets will depend on a range of factors including:

- the proportion of the total income generated by the personal asset that is realised when the asset is sold. The greatest improvements in economic efficiency will arise from the removal of current exemptions in respect of personal assets that generate most of their income when they are sold rather than as imputed income;
- the extent to which any real loss realised on sale is attributable to the derivation of imputed rental income; and
- the treatment of real losses incurred in respect of such assets.

### **13.4.1 Appreciating Personal Assets**

Consider first the case of a personal asset that is expected to appreciate in real value over its life. In this instance, the taxation of income realised when the asset is sold would tend to improve economic efficiency by reducing the existing tax bias in favour of personal assets, even though the imputed rental income derived from that asset remains tax free. In contrast with the existing situation where all income from such assets is tax free, the owner of the personal asset would expect to pay tax on the income realised when the asset is sold.

### **13.4.2 Depreciable Personal Assets**

Many consumer durables are expected to fall in real value over time. In most cases, the real depreciation will largely be due to wear and tear resulting from personal use. The recognition of losses on such assets for tax purposes would tend to reduce economic efficiency by increasing the existing tax preference for these assets.

For this reason, it is desirable to avoid the deductibility of losses for personal assets that are expected to depreciate in real terms. It is not practicable, however, to predict with certainty which personal assets will decline in value. While one approach would be to require taxpayers to compute income or losses derived on the disposal of personal assets (with such income and losses perhaps being ring fenced), a preferable approach from the point of view of minimising compliance costs would be to continue to exempt income and losses in respect of depreciable personal assets. Hence, income or losses on the sale of most personal assets would not be taken into account for tax purposes.

### **13.4.3 Treatment of Expenses**

If part or all of the income generated by personal assets were brought within the tax system, it would be necessary to consider how expenses relating to such assets should be treated. The most important types of expense are interest and repairs and maintenance costs.

Section 104 is the principal section of the Act providing for the deductibility of expenses. The section permits a taxpayer to deduct any expenditure or loss to the extent to which it is "incurred in gaining or producing the assessable income for any income year" or is necessarily incurred in carrying on a business for that purpose. A similar test in section 106(1)(h) applies to the deductibility of interest. These sections must, however, be read in conjunction with section 106(1)(j) which disallows a deduction for any expenditure or loss "to the extent to which it is of a private or domestic nature".

Repairs and maintenance and interest costs incurred on personal residences are clearly incurred for private or domestic purposes. In most cases, such costs are incurred wholly for these purposes. Under present law, therefore, most

home owners are not entitled to a deduction for interest or repairs and maintenance costs relating to their houses.

Where a taxpayer is able to show that part or all of such expenditure is not of a private or domestic nature and is connected with the production of assessable income, a proportion of the expenditure equal to the proportion that is not of a private or domestic nature is deductible. The basis for such an apportionment is, however, not clear and, in practice, section 106(1)(j) has proven to be difficult to apply. Consequently, it would be desirable to clarify the present law for determining how expenditure on personal assets should be treated.

The treatment of expenditure relating to personal assets is discussed in more detail in Chapters 14 and 16.

#### **13.4.4 Conclusion**

The preceding analysis suggests that income realised on the sale of personal assets, other than assets that are expected to decline in value as a result of personal use, should be assessable. The implications of this conclusion for the taxation of particular types of personal assets are examined below.

### **13.5 Personal Residences**

#### **13.5.1 General**

The most important class of personal assets are personal residences. Personal residences such as houses are used principally for private and domestic purposes. Current valuations indicate that residential housing accounts for approximately 36% of the total value of real property. Approximately 76% of houses are owner-occupied. As noted previously, the Government Statistician estimates that imputed income from owner-occupied dwellings was \$2.9 billion in 1986/87. Thus, the treatment of personal residences has significant consequences for the economy.

Houses are subject to real depreciation in the sense that older houses are generally worth less than new houses of a similar size and location. Land, however, is not a depreciating asset and may show real gains. Over the past 27 years, inflation has accounted for most of the increase in residential house prices. Between 1961 and 1988, house prices increased by an average of 10.1% per year, but once adjusted for inflation, house prices increased on average by only 0.7% per year. Even this figure overstates the true rate of increase in that it does not adequately allow for improvements in the quality of housing.

As might be expected, there is some regional variation in price changes. For example, over the 25 year period from 1962 to 1988, real house prices increased by 2.6% per annum in Auckland, 0.6% per annum in Wellington and 0.5% per annum in Christchurch. In the rest of New Zealand, house prices generally declined slightly in real terms.

In view of these small rates of increase in the real value of houses, the compliance costs of attempting to measure real gains on personal residences are likely to be excessive in many cases, particularly since most home owners are not used to keeping detailed records for tax purposes. For the reasons outlined previously, however, a total exemption for sales of personal residences would also cause problems. For example, higher-income taxpayers, who would be most affected by the reforms, would be induced to mitigate their effect by increasing their investment in houses, thereby pushing up the price of higher-priced homes.

In order to avoid the problems created by a total exemption of houses while ensuring that most ordinary homes do not give rise to a tax liability on sale, an indexed standard annual allowance set at a level such as \$4,000 should be able to be added to the acquisition cost of a house (unless the owner elects to keep records sufficient to verify the actual amount of expenditure incurred on capital improvements). Any profit on sale would be computed after taking into account this allowance and the effects of inflation since purchase.

This mechanism would ensure that most ordinary homes would not generate a tax liability on sale. It would apply only to the principal residence of a taxpayer. For example, if a person owns two houses, one of them would be the person's principal residence (and thus would be eligible for the standard annual allowance) while the other would be treated in the same way as other property.

### **13.5.2 Expenditure on Capital Improvements**

Expenditure on capital improvements to personal residences should be deductible in the income year in which sales proceeds are recognised for income tax purposes. As mentioned above, in order to reduce compliance costs, taxpayers should have the option of claiming:

- the actual amount of the costs of improvements in relation to the dwelling; or
- a standard annual allowance.

Where a residence is jointly owned, the allowance would be apportioned between the owners.

Where a dwelling is used by a taxpayer for both business and personal purposes, the part of interest and repairs and maintenance expenditure that is not deemed to be private or domestic expenditure would continue to be deductible. As noted previously, the deductibility of expenditure relating to personal use assets is discussed in more detail in Chapter 16.

### **13.5.3 Other Issues**

A number of other issues need to be addressed regardless of whether or not income derived on the sale of personal residences is taxed. To the extent that there are special rules for calculating income on the sale of personal residences, it would be necessary to define such assets where they form part of larger assets (e.g., a personal dwelling on a farm property or a mixed owner-occupied and rental dwelling). Current rules that define dwellings that are exempt from stamp duties when sold could provide a suitable basis.

## **13.6 Cars, Boats and Other Household Durables**

The real depreciation on cars, boats, and other household durables represents a significant part of the expected cost of owning such assets. When these assets are sold, households in most cases will record a real loss. Because this loss can be regarded as the cost of deriving untaxed, non-monetary income in the form of the consumption services provided by the asset, the loss should not be deductible.

Hence, it is proposed that, in general, income or losses in respect of cars, boats and other household durables should not be recognised for tax purposes except where they are acquired because they are expected to appreciate. This distinction is discussed further in Chapter 14.

## **13.7 Jewellery, Fine Art and Collectables**

Investments in jewellery, fine art and collectables (including such items as rare coins, vintage cars etc.) warrant a somewhat different treatment from depreciable personal assets because an important motive for holding them may be investment, even if they yield personal benefits ("consumption services") to their owners. Unlike depreciable personal assets that are expected to decline in value in real terms over their life, these types of asset are usually expected to increase in value in real terms.

In view of this consideration, any income realised on the sale of jewellery, art and collectables should be taxable. Interest incurred on money borrowed to buy such assets and other expenses should be treated according to the current rules.

The compliance costs of computing income in respect of such assets would be reduced by continuing to exempt income realised on assets with a value below a certain threshold. This is discussed in more detail in Chapter 14.

## **13.8 Conclusion**

The neutrality objective of tax reform requires that current exemptions that apply to income realised on the sale of assets should be removed in respect of all business assets and appreciating personal assets. This would mean that real income realised on the sale of personal residences and other appreciating



personal assets would be taxable, with expenditure on capital improvements (or, in the case of housing, at the election of the taxpayer, the standard caused allowance) being deductible in the year the property is disposed of.

Personal assets that are expected to decline in value in real terms over their life (depreciable personal assets) should continue to be outside the tax base since the losses reflect the benefits of untaxed private and domestic use.



**PART III: REMOVAL OF EXEMPTIONS**  
**B: DETAILS OF DESIRABLE REFORMS**



# CHAPTER 14: MAIN FEATURES

## 14.1 Introduction

Part IIIA of this Document outlined the principal policy questions relating to the removal of the present exemptions for certain forms of income from capital. The purpose of this part is to translate the conclusions of Part IIIA into specific reform proposals and to consider a number of lesser, though nevertheless important, details.

This chapter deals with the main features of the proposed reforms. In particular, it outlines:

- which income and expenditure should be included within the scope of the reforms;
- how income and expenditure would be calculated;
- when income and expenditure would be recognised for tax purposes; and
- which taxpayers would be subject to the reforms.

A number of these questions are discussed further in later chapters.

Following the conclusions in Part II, this Chapter assumes that expenditure deductible in the year of sale would be indexed for inflation. Hence, only real income would be taxable, while real losses would be deductible.

## 14.2 Definition of Assessable Income

### 14.2.1 General Principle

The general principle is that income realised on the disposal of property that is currently exempt from income tax should be assessable unless an explicit decision is made to leave it exempt. It does not matter whether the property is tangible or intangible. Similarly, expenditure relating to such property that is currently not recognised for tax purposes should be deductible (subject to certain restrictions outlined below).

Where the income is derived by a New Zealand resident, it does not matter whether the property disposed of is located in New Zealand or elsewhere. Non-residents, however, should be assessable only on income with a New Zealand source. (See section 14.5.3 below for a definition of New Zealand-source income.)

The above general approach would mean that as income or losses derived on the disposal of land, buildings, depreciable plant and machinery, shares, commodities, leases and other forms of tangible and intangible property would be recognised for tax purposes. With respect to depreciable assets, this would mean that the present original cost ceiling on the extent of depreciation recapture on disposal would be removed so that gains in excess of the indexed book value of depreciable assets would be assessable. (This is discussed further in Chapter 16.)

### **14.2.2 Income Derived on the Sale of Personal Assets**

As discussed in Chapter 13, most personal assets (such as household furniture, appliances and motor vehicles), other than houses and certain specified assets (as defined in section 14.2.3) decline in value (in real and often nominal terms) because of wear and tear. A disposal of such an asset will therefore typically result in a loss. These losses should not be deductible for tax purposes - first, because they are predominantly attributable to personal use (or, more precisely, they are attributable to the production of untaxed, non-monetary income derived by the owner of the asset); and, secondly, because the compliance costs associated with calculating indexed income and losses on typically small-value personal assets would be excessive in relation to the revenue derived or real losses sustained.

Accordingly, income or losses derived on the disposal of personal assets that normally fall in value should not be recognised for tax purposes. This will be referred to as "exempt property" (see section 14.2.3 below). Where, however, the purpose or one of the purposes of acquiring property is to derive monetary gains, income derived on the disposal of the property should be recognised for tax purposes.

### **14.2.3 Definition of Exempt Property**

As noted in the previous section, income from certain personal assets should remain outside the tax system. This category will be referred to as "exempt property". Exempt property would be defined as personal assets which consist of:

- household appliances, furniture and other household and personal effects, other than antique furniture that has a market value at the time of its acquisition, or the implementation date of the reforms, whichever is later, above a certain threshold, such as \$2,000;
- jewellery, other than jewellery that has a market value at the time of its acquisition, or the implementation date of the reforms, whichever is later, above a certain threshold, such as \$5,000;

- motor vehicles, other than vintage and rare motor vehicles that have a market value at the time of acquisition, or the implementation date of the reforms, whichever is later, above a certain threshold, such as \$20,000;
- works of art, such as paintings, pottery or sculpture, other than works of art that have a market value at the time of their acquisition, or the implementation date of the reforms, whichever is later, above a certain threshold, such as \$5,000; and
- collectables, such as rare stamps, coins or books, other than collections that have an aggregate market value at the time of their acquisition, or the implementation date of the reforms, whichever is later, above a certain threshold, such as \$1,000.

While taxpayers may acquire appreciating property, such as antique furniture or valuable jewellery, for purposes other than the derivation of profit on sale, the nature of the assets is such that they are expected to appreciate. Hence, the effect of an acquisition is that taxpayers can generally expect to make a profit on disposal. For this reason, certain types of personal assets that can be expected to appreciate would be excluded from the definition of exempt property.

The purpose of the various thresholds is to avoid the necessity to bring to account small amounts of income where the compliance and administrative costs of doing so would usually be excessive.

### **14.3 Calculation of Taxable Income**

The income recognised for tax purposes on the disposal of property would be calculated as the consideration received or receivable. Deductions would be permitted in the year of disposal for the cost of the property, adjusted for the effects of inflation.

#### **14.3.1 Value of Consideration**

Where the consideration is money, its value is simply the amount of money. Where the consideration is in a non-monetary form, the value of the consideration is its market value at the time of the disposal.

Where payment of the consideration is deferred, a financial arrangement may arise. Sections 64B-M of the Act would then govern the recognition of income and expenditure under the deferred payment arrangement. The value of the consideration for the property transferred pursuant to the arrangement would

be the market value of the property at the date it is acquired.

Where no consideration passes, such as when an asset is transferred by gift or bequest, the consideration should be deemed to be the market value of the asset on the date of transfer.

### 14.3.2 Capital Expenditure

As noted in the previous section, gross proceeds from the disposal of property would be assessable income in the year of disposal. The cost of the property and any expenditure incurred on improvements to the property (other than expenditure that is deductible as repairs and maintenance) would be capitalised and deducted in the year of disposal.

The initial acquisition cost of any property would be defined to mean:

- where the property is acquired after the implementation date of the regime, the acquisition cost of the property;
- where the property is acquired after the implementation date other than by way of an arm's length transaction, its market value on the date of acquisition;
- where the asset was acquired on or before the implementation date of the regime, the amount determined according to the transition rules outlined in section 14.7.

The initial acquisition cost, adjusted for inflation, would be deductible in the year in which the property is disposed of. In addition, any amounts incurred on altering or improving the asset (i.e., capital improvements), not including expenditure on repairs and maintenance which is or was allowable as a deduction for tax purposes, would be deductible in the year of disposal, once again after adjustment for inflation.

As discussed in the Preface, to ensure that sales of most ordinary houses do not give rise to a tax liability and to minimise compliance costs where indexed gains on disposal are typically going to be small, owners of personal residences would be able to deduct either:

- the actual amount spent on capital improvements, supported by the necessary records; or
- a standard annual allowance of, say, \$4,000 for expenditure on capital improvements. For example, if a taxpayer owns a house for five years and then sells it, the taxpayer would be deemed to have spent \$20,000 (i.e., 5 times \$4,000) on capital improvements unless actual capital expenditure can be shown to exceed this figure.



The standard annual allowance would be available only in respect of a taxpayer's principal residence.

### 14.3.3 Indexation Adjustment

As noted above, the calculation of taxable income on the disposal of assets should take into account the effects of inflation. The method of indexation was outlined in Chapter 5 of Part II. In brief, the acquisition cost of property and amounts spent on capital improvements (or the standard annual allowance, if a taxpayer so elects in the case of personal residences) would be indexed for the change in the CPI between the quarter in which the property was acquired or the expenditure was incurred and the quarter in which it is disposed of.

### 14.3.4 Expenses Relating to Personal Assets

As noted in Chapter 13, the current distinction between expenditure incurred for business purposes and expenditure incurred for private or domestic purposes will be continued for interest on money borrowed to acquire a personal residence and operating and maintenance expenses. Accordingly, such expenditure would continue to be treated as expenditure of a private or domestic nature (and so non-deductible) except to the extent to which it is an additional cost relating to the use of the dwelling in an income-earning activity.

A similar rule would apply to interest and other expenditure relating to other property used for private or domestic purposes. The treatment of expenditure relating to personal assets is discussed further in Chapter 16.

### 14.3.5 Summary

In summary, when a person sells or otherwise disposes of property, other than exempt property, the person would:

- return as assessable income the consideration or deemed consideration derived from the sale or disposal; and
- deduct the cost of the property, including the cost of improvements, after adjustment for the effects of inflation since the cost or expenditure was incurred.

## 14.4 Timing of Recognition

### 14.4.1 General Rule

Assessable income derived on the disposal of an asset would generally be recognised in the year of disposal. A **disposal** in relation to any property would be defined as the sale or other disposition of the property. This would include, for example, a gift or bequest of an asset. The definition of a disposal

is discussed in more detail in Chapter 15.

In addition, certain assessable income would be recognised in the income year in which a person emigrates. This is also discussed in Chapter 16.

#### **14.4.2 Exempt Disposals**

In some cases, a transfer of property does not change the ownership of the property in an economic sense. For example, an asset may be sold by one company to another company, both of which are owned by the same person. Similarly, an asset may be sold by a person to a company owned by the person. In these cases, there is a change in legal ownership, but no change in the economic ownership of the asset. Accordingly, the disposal of property:

- by a person to a company which is wholly owned by the person, or vice versa; or
- by one company to another company in the same specified group of companies -

should not give rise to a disposal for tax purposes. Instead, the cost of the property in the hands of the transferee should be carried over to be the cost of the property for the transferor. This provision would be accompanied by a rule to ensure that the income not recognised at the time of the transfer is recognised if the company to which it has been transferred is subsequently sold.

These proposals are discussed in more detail in Chapter 15.

#### **14.4.3 Loss Ring-Fencing**

As discussed in Chapter 12, losses relating to certain types of property which yield assessable income on disposal need to be ring-fenced to reduce scope for avoidance. Under this approach, all losses derived on the disposal of assets would be ring-fenced, except losses relating to sales of:

- trading stock;
- depreciable or real property used in a business;
- financial arrangements;
- intangible property, such as patents and copyrights, where such income or losses are not currently recognised for tax purposes.

Ring-fencing would mean that:

- losses would be able to be deducted only against profits or gains derived on the disposal of property, other than the property listed above;
- to the extent that such losses exceed in any income year the specified profits or gains derived by the person in that year, the excess loss would be able to be carried forward for deduction against the specified profits or gains derived by the person in subsequent income years.

As noted, ring-fencing should not apply to ordinary income and losses, such as income and losses on the disposal of trading stock or financial arrangements. Further, ordinary losses should be deductible against all forms of capital income.

## **14.5 Persons Liable**

### **14.5.1 Residents**

All New Zealand residents should be liable for tax on income derived on the disposal of property. As is the case for income tax purposes at present, residents should be assessable on income irrespective of whether it is derived from the disposal of property located in New Zealand or overseas. That is, residents should be assessable on both New Zealand and foreign-source income derived on the disposal of assets.

Further discussion of the treatment of income derived by residents on the disposal of assets held offshore is included in Chapter 16.

### **14.5.2 Non-Residents**

As with other forms of income, non-residents should be assessable in New Zealand on income derived on the disposal of property that has a New Zealand source. As for residents, a deduction would be allowed in the year of disposal for capital expenditure relating to the property.

There would be no change in the way in which non-residents are taxed on income derived from financial arrangements, as defined in section 64B.

### **14.5.3 Definition of New Zealand-Source Income**

The definition of income that has a source in New Zealand is contained in section 243 of the Act. This section would continue to apply but would need to be amended to accommodate the reforms outlined. In particular, income derived on the disposal of New Zealand-source property would need to be included in the definition.

New Zealand-source property should be defined to include:

- land and buildings that are in New Zealand; and
- shares in a New Zealand resident company, other than shares listed on the New Zealand stock exchange.

Income derived from the sale of movable property would not be included in the source rule. These proposals are discussed further in Chapter 16.

## 14.6 Transition

All income derived on the disposal of property that has accrued **after** the date of implementation of the reforms would be recognised for tax purposes, irrespective of whether the property was acquired before or after the implementation date. Transitional provisions would apply for the purposes of determining the deemed acquisition cost of property acquired on or before the implementation date. In general, the deemed acquisition cost would be the market value of the property on the implementation date. There would be no requirement to establish this value prior to the disposal of the property.

Where the market value of an asset on the implementation date cannot readily be determined, taxpayers would instead use the time apportionment method outlined in Chapter 17. Under this method, the deemed acquisition cost of the property would be determined by prorating the difference between the actual acquisition cost of the property and its sale price over the period, before and after the implementation date, that the property has been held. For example, assume that an asset was acquired for \$1,000 and sold for \$1,300 and that it was held for, say, 30 months, 10 of which preceded the implementation date. The difference between the sale price and cost of the asset is \$300. The deemed acquisition cost of the asset would be calculated as:

$$\$1,000 + \$300 \times 10/30 = \$1,100.$$

## 14.7 Effect on Taxpayers

### 14.7.1 Non-Business Taxpayers

Most taxpayers who do not own a business would be affected by the above reforms if they own assets, such as shares, that are not exempt property. Taxpayers owning houses or other residences would, however, derive taxable income on the disposal of the residences only if their rate of appreciation exceeds the rate of inflation after taking into account the standard annual allowance.

In practice, real rates of increase in the value of houses have historically been low, at around 0.7% per annum on average. Once the cost of capital improvements or the standard allowance, whichever is adopted, is taken into account, most taxpayers would pay no or only small amounts of tax on the sale of their houses. This conclusion is illustrated in Annex 14.1 using historical data.

Where other non-exempt property is disposed of, income derived would be assessable. Once again, a tax liability would arise only where the rate of increase in the value of the property exceeds the rate of inflation.

#### **14.7.2 Business Taxpayers**

Business taxpayers would be in the same position as non-business taxpayers with respect to the sale of houses and other non-exempt property. In addition, business taxpayers would be taxed on any income derived (after taking into account the effects of inflation) on the disposal of business assets.

#### **14.8 Further Details**

Further details of a number of the above areas are outlined in subsequent chapters. Appendix 4 outlines the main design aspects of capital gains tax regimes in a number of other countries.

## **ANNEX 14.1**

### **Implications of the Taxation of Income Derived on the Sale of Houses**

#### **Introduction**

The purpose of this annex is to examine the effects of taxing income derived on the disposal of an average house based on the proposals outlined in Chapter 14. The analysis is based on historical changes in house prices and changes in the consumer price index ("CPI").

#### **Assumptions**

The analysis assumes that:

- income derived on the sale of houses was subject to tax in respect of houses sold on or after December 1961;
- a house acquired for the average price of a house in any year is later sold for its estimated price in the year of sale, calculated as the original price adjusted by the change in the nominal price index for houses between the relevant year and the year in which the house is assumed to be sold;
- the homeowner claims the proposal standard deduction equivalent to \$4,000 in 1988 dollars in respect of each year the dwelling is owned. The aggregate amount of this expenditure is capitalised and deducted in the year in which the house is sold;
- the acquisition cost of the house is indexed by the proportionate increase in the CPI between the year the house was acquired and the year it is sold;
- the tax rate in each income year is 33%; and
- houses are assumed to be acquired or disposed of on the last day of any year.

#### **Data**

The nominal housing price index for December quarters and the CPI for each of the years 1961 to 1988 are shown in Table 14.1 below. The table also shows average house prices for each year.

**Table 14.1.1**  
**Nominal House Price Indexes,**  
**Consumer Price Indexes and**  
**Average House Prices 1961-1988**

Year Ending 31 December	Nominal Housing Jun-80 =1000	CPI Annual Index Jun-80 =1000	Average House Price (\$)
1961	244	223	7,044
1962	244	228	7,196
1963	250	234	7,531
1964	263	244	7,902
1965	278	249	8,307
1966	294	256	8,773
1967	294	272	8,991
1968	302	287	9,398
1969	315	297	9,947
1970	340	327	10,917
1971	379	358	11,476
1972	441	376	13,696
1973	593	414	18,528
1974	769	467	24,151
1975	808	541	25,698
1976	859	624	28,086
1977	897	721	29,384
1978	914	792	30,590
1979	958	924	31,837
1980	1056	1074	34,856
1981	1374	1241	42,994
1982	1686	1431	52,370
1983	1834	1482	59,471
1984	2066	1622	67,125
1985	2362	1871	78,044
1986	2537	2211	87,591
1987	3089	2424	104,511
1988	3311	2538	105,284

## Results

Based on the information contained in Table 14.1 and the assumptions outlined, the effect of taxing income derived on the sale of houses can be explored for different holding periods. The net taxable income or loss on sale for 1988 for various holding periods is shown in Table 14.2. The tax payable or tax credit carried forward is also shown.

The major conclusion that can be drawn from this data is that houses sold in 1988 after having been held for more than two years would generally have incurred a substantial tax loss on sale. The average turnover rate of housing over the eight years from 1981 to 1988 was 8.3 percent. This implies that the average holding period of houses is at least 12 years. Thus, most average houses would not have been taxed.

Other analysis reveal that an average house sold in any year and for the average holding period over the entire 1962-1988 period would not have been liable for tax. Furthermore, the maximum amount of tax that would have been payable for any holding period and for any such period between 1962 and 1988 was \$2,352 for houses sold in December 1987 that had been acquired the year before. The \$2,352 tax liability represents 2.2% of the total value of the average house in 1987 and 12% of the realised nominal gain.



**Table 14.1.2****Tax Treatment of an Average House Sold in 1988**

The following table shows the tax treatment that would have been accorded an average New Zealand house sold in 1988, if the proposals in the Consultative Document had been in place since 1961.

Number of Years Owned	Purchase Price	Profit/(Loss) on Sale	Tax Payable on Sale
1	\$104,511	(\$1,414)	
2	\$87,591	\$5,750	\$1,897
3	\$78,044	(\$8,494)	
4	\$67,125	(\$13,472)	
5	\$59,471	(\$14,468)	
6	\$52,370	(\$14,009)	
7	\$42,994	(\$12,317)	
8	\$34,856	(\$5,114)	
9	\$31,837	(\$13,431)	
10	\$30,590	(\$27,231)	
11	\$29,384	(\$39,003)	
12	\$28,086	(\$53,914)	
13	\$25,698	(\$67,343)	
14	\$24,151	(\$83,271)	
15	\$18,528	(\$70,218)	
16	\$13,696	(\$53,712)	
17	\$11,476	(\$49,134)	
18	\$10,917	(\$50,316)	
19	\$9,947	(\$56,463)	
20	\$9,398	(\$60,132)	
21	\$8,991	(\$66,772)	
22	\$8,773	(\$76,061)	
23	\$8,307	(\$77,828)	
24	\$7,902	(\$78,831)	
25	\$7,531	(\$82,118)	
26	\$7,196	(\$86,308)	
27	\$7,044	(\$92,461)	

## Notes

- 1 The profit or loss on sale is calculated using the data in Table 14.1.1.
- 2 A standard allowance of \$4,000 in 1988 dollars is assumed through the period.
- 3 A marginal tax rate of 33 percent is used.
- 4 The sale price of the house is taken to be its purchase price inflated by the nominal house price index.
- 5 The purchase price of the house is taken to be the average price of a dwelling in the year of purchase.

# CHAPTER 15: DEFINITION OF A DISPOSAL

## 15.1 Introduction

In Chapter 14, it was noted that assessable income derived on the disposal of property should be recognised in the year of disposal. Similarly, the cost of the property and any capitalised expenditure on improvements to it should be deductible in the year of disposal. While there is usually no difficulty in determining the year of disposal in a straightforward sale, more complicated methods of disposition necessitate the development of special rules which define when a disposal occurs.

Sometimes a transaction takes the form of an exchange of non-cash assets rather than a sale of an asset for money. On other occasions, a transaction amounts to a partial transfer of rights to the property. Sales may have conditional consideration or involve some other contingency. Further, assets may be transferred without any consideration passing.

All of these cases, and others, must be dealt with under any regime that aims to tax income derived on the disposal of property. The primary purpose of this chapter is to discuss the definition of a disposal in more detail.

A disposal of property that gives rise to the recognition of income for tax purposes will be called a "taxable disposal".

## 15.2 Criteria for Determining a Taxable Disposal

The main criteria for determining when a taxable disposal occurs should be:

- the promotion of neutrality;
- the minimisation of administrative and compliance costs;
- the prevention of tax avoidance transactions; and
- the promotion of public perceptions of fairness.

It is not always possible to meet all four objectives simultaneously. An explicit tradeoff among them may therefore be necessary.

The first criterion is to promote neutrality. As noted in Chapter 12, the taxation of income on a realisation rather than an accrual basis results in two types of departures from full neutrality and thereby creates two sources of efficiency loss. First, the effective tax rates on assets that appreciate in value are lower than the effective tax rates on assets with immediate cash flow returns. The second source of non-neutrality is the "lock-in" effect.

The second criterion is ease of compliance and administration. Considerations of both neutrality and ease of compliance and administration suggest that all arm's length sales should be treated as disposals. Other types of asset transfer should also be treated as disposals where valuations are relatively easy, or where efficiency costs are unduly large in the absence of recognition.

The third criterion is the prevention of tax avoidance transactions. This means that the rules should not allow taxpayers to avoid the recognition of income by disguising the true economic nature of transactions. This in turn means that the rules should depend on an economic rather than a strictly legal concept of ownership. The transfer of the economic burdens and benefits of ownership should be a disposal, even if formal legal title to the transferred asset does not change hands.

The need to prevent tax avoidance may also necessitate rules to ensure that all accrued income derived on the disposal of an asset is subject to tax. For example, transfers of property outside the tax base (e.g. to non-taxpaying entities) may need to be treated as taxable disposals.

The final criterion is perceived fairness. It is important that people should perceive that the income tax treats them fairly and reasonably by applying general principles in an even-handed way. The tax system will not be sustainable if people consider that the rules for determination of assessable income are opportunistic and arbitrary.

## **15.3 Sale or Exchange of Ownership Rights**

### **15.3.1 Ownership Rights**

In establishing rules to govern the recognition of income on disposals of property, it is necessary to consider the nature of the rights that attach to property.

The benefits and burdens of ownership of an asset include:

- rights to exclusive use of the asset to generate current services (i.e. assessable or imputed income); and
- rights to reap the rewards (or incur the costs) of any changes in the future economic returns attributable to the asset. (For convenience, these rights will be referred to as "proprietorship rights").

While use and proprietorship rights have been separately identified, they are intimately related. For example, if a taxpayer rents a dwelling for one year to a tenant in consideration for a market rental, the taxpayer has temporarily disposed of the right to use the dwelling in consideration for the rental income.

Few proprietorship rights have been alienated by the taxpayer. The taxpayer would reap most of the benefit if the value of the property doubled during the year. Likewise, the taxpayer would bear most of the cost if property prices halved over the year.

If, however, the taxpayer sells the dwelling, he or she would be disposing of all use and proprietorship rights for consideration which, in principle, will be equal to the present value of the future returns the asset is expected to yield. The seller has, in a sense, locked in any expected future change in the value of the property at the time it is sold. The benefits or burdens of any unanticipated changes in the returns from the asset would thereafter be borne by the purchaser.

An intermediate position between the above two examples is the case of a short-term lease of a property where market rents are fixed periodically. An asset may be leased for a limited period for a fixed rental based on, say, expected future market rentals. To the extent that such future lease payments are fixed and are therefore locked in, the lessor disposes of some of the proprietorship rights in respect of the asset leased. For example, suppose that a residential property is leased for a fixed period in consideration for fixed and certain lease payments during the term of the lease and that property prices and rentals double during the term of the lease. The tenant would reap the rewards due to the change in the economic yield attributable to the dwelling. The tenant's benefit is the extent to which the fixed rentals are less than the market rental that would have been paid if the rental payments had not been fixed.

Hence, transactions between taxpayers may involve full or partial transfers of use and proprietorship rights. A full exchange of these rights in relation to any property occurs when the transferor permanently and unconditionally disposes of all of the rights attaching to a property. A partial disposition of property includes the permanent disposition of part of the rights in respect of the property, or the disposition of all or some of the rights in relation to the property for a limited period.

As noted previously, a transfer of the economic benefits and burdens of ownership should be treated as a taxable disposal, even if formal legal title does not pass. In other words, the focus should be on changes in beneficial ownership of property rather than on changes in legal ownership. If there has been a change in beneficial ownership, it is appropriate to recognise income. Thus, for example, the creation of a trust over property should be a taxable disposal at the time that the trust is created. Another example of a change in beneficial ownership which should be treated as a taxable disposal is where a legal or equitable owner of property assigns his or her interest in that property in a contract for valuable consideration.

The following sections explore full and partial dispositions in more detail.

### **15.3.2 Sales of Property for Unconditional Consideration**

The timing and extent of a change in beneficial ownership rights will be easiest to determine where all the rights in respect of the asset are sold unconditionally and at arm's length in exchange for consideration. Such sales would include most normal transactions which involve the outright sale of an asset in exchange for money. They would also include the outright sale of an asset in full or partial exchange for another asset (e.g. a "trade-in"). The latter type of exchange is equivalent to two separate transactions, the first being the sale of the asset in question for cash and the second being the acquisition of the new asset with the sale proceeds. In both cases, the transfer should be treated as a taxable disposal.

### **15.3.3 Sales Involving Financial Arrangements**

The timing and extent of changes in ownership rights should also be readily apparent when all the rights in relation to an asset are sold but the sale involves a financial arrangement. This would include, for example, the outright sale of an asset where payment for the asset is deferred or spread over a specified time period. In these instances, the appropriate treatment is to deem the asset to be realised at its market value at the time the property is transferred. The tax treatment of the deferred payments would be governed by the accrual rules for financial arrangements.

### **Hire purchase agreements**

Property may be sold subject to hire purchase agreements. A hire purchase agreement is economically equivalent to a combination of an immediate sale and a loan from the seller to the purchaser. The loan amount is equal to the sale price and the initial payment on the contract. Even though such agreements are similar to financial arrangements, they are not covered by the accrual rules.

The current treatment of hire purchase agreements differs significantly from the treatment of economically equivalent sale and loan transactions. Under current treatment, profits on trading stock sold under hire purchase agreements are assessable income, but a reserve deduction is allowed for the net profit element which is then brought into income upon receipt of hire purchase payments. This treatment allows a substantial deferral of tax liability.

The correct rules would deem property disposed of pursuant to a hire purchase agreement to be realised at its market value. The difference between the deemed sale price (less any costs associated with the disposition) and the cost of the asset would be assessable income to the seller. In subsequent years, the interest portion of imputed loan repayments would be assessable income to the

seller and a deductible expense (if appropriate) to the buyer.

A change to the treatment of hire purchase agreements for the sale of property, other than trading stock, would be needed at the same time as the removal of the current exemptions.

#### **15.3.4 Partial Dispositions**

The timing and extent of changes in property rights would be more difficult to determine when the assets are partially disposed of. Given the complexity and variety of transactions, judicial interpretation would inevitably be necessary to precisely define the boundaries imposed by any statutory rules. To facilitate this, it is highly desirable that general principles for the treatment of partial dispositions be established in legislation.

As noted above, a partial disposition of an asset occurs where a taxpayer disposes of some of the rights in respect of the property permanently, or some or all of the rights for a limited time period. It was also noted previously that whether or not a partial disposition of any of these rights should be treated as a taxable disposal should depend on the extent to which the disposition represents a change in the economic benefits and burdens of ownership.

The permanent disposition of some of the rights in respect of an asset can occur in a number of ways. Two means by which this can occur are:

- the sale of some of the rights; and
- the sale of some or all of the rights for contingent consideration.

More complex commercial transactions may involve both of these two approaches.

#### **Partial Sale of Rights**

A taxpayer may dispose of part an asset. For example, a taxpayer may dispose of part of a block of land he or she owns. In such circumstances, the part sale should be treated as a taxable disposal. The seller would be taxed on the difference between the proceeds and the cost of the asset attributable to that part of the asset sold. The cost of the property should therefore be apportioned between the part that is sold and the part that is retained. In general, this apportionment should be done by prorating the market value of the property between the part sold and the part retained. If the interest in the property remaining after the disposition is subsequently sold by the taxpayer, any income or losses in respect of that interest would be recognised at that time.

## **Sale of some or all rights for contingent consideration**

A taxpayer may sell all or some of the rights in relation to property where the amount of consideration depends on certain conditions. For example, a taxpayer may sell a business for, say, \$1 million payable when the business is transferred to the new owner plus an additional payment of \$100,000 if certain conditions (such as specified levels of profitability or turnover in the first year after sale) are met. Equivalently, a taxpayer may sell a business for \$1.1 million that is paid when ownership of the business changes, with a provision that the seller must rebate \$100,000 if certain conditions are not met.

Where the contingent consideration is in substance a deferred payment (i.e., the payment is not contingent), a financial arrangement would exist and the rules previously outlined in section 15.3.3 would apply. The remainder of this section assumes that a payment is indeed contingent on some future event or circumstance.

In such cases, a disposal should be treated as a partial disposal. Payments for the property under consideration would be recognised as assessable income in the year in which they are received or become receivable, whichever is the earlier. Where the maximum consideration is known or can be estimated with reasonable certainty, the cost of the property should be deductible in proportions which correspond to the proportions of the total consideration which are recognised in any year. In the example mentioned in the earlier paragraph, the first payment of \$1 million would be assessable in the year it is receivable. Since this represents 10/11 of the total consideration, 10/11 of the cost of the property would be deductible in that year. The remaining 1/11 of the cost would be deductible in the year in which the balance of the consideration becomes assessable. If there is no further consideration payable (i.e., the condition necessary for the payment of the contingent part of the consideration does not eventuate), the balance of the undeducted cost would be deductible in the year in which it becomes certain that the contingent consideration will not be payable.

In some circumstances, it may not be possible to determine the maximum consideration payable, although this is likely to be the case only in non-arm's length arrangements. In such cases, it may be necessary to recognise income in the year in which it becomes receivable but defer deductibility of the cost of the property until the year in which the total consideration receivable becomes known with certainty.

### **15.3.5 Options**

A taxpayer may dispose of an asset subject to the exercise of a discretion by another party. This may occur in several ways, including:



- the granting of an option to another person that entitles that other person to acquire all or a part of an interest in the property for a predetermined consideration at some future date or if a specified event occurs (known to as a "call" option); or
- the acquisition of an option by the owner of an asset that entitles the owner to require the person who granted the option to acquire all or some of the owner's interest in the asset for specified consideration at some future date (known as a "put" option).

### **Treatment of the Option**

The accrual rules in sections 64B-M of the Act determine the income tax treatment of most income and losses under option contracts. These rules do not, however, extend to income from options in respect of shares, short term options and options in respect of property that are granted for private or domestic purposes only.

Where the accrual rules do not apply, the issuer of an option should be subject to tax in the year of issue on the proceeds from the issue of the option, with any expenditure incurred in the process being deductible in that year. Any additional income or losses would be recognised when the option is exercised.

If an option lapses through the passage of time, the holder should be deemed to have disposed of it for no consideration at the time it lapses. The holder would deduct the cost of the option, if any, in that year.

These rules for the treatment of options would need to be integrated with those that govern the treatment of options that are subject to the accrual rules.

### **Treatment of the Underlying Asset**

The exercising of an option over a property should give rise to a taxable disposal. The seller of the asset should be deemed to realise the asset for the amount he or she receives as a result of the exercise of the option. The purchaser would be deemed to acquire the asset for an amount equal to the sum of the amounts paid to acquire and to exercise the option (less any amounts received in consideration for holding an option to buy the asset).

#### **15.3.6 Temporary Dispositions: Leases**

##### **Leases Equivalent to Disposals**

Partial dispositions also occur when taxpayers dispose of property on a temporary basis. As noted previously, such transactions may be limited to the disposition of rights to the use of an asset for a certain period in consideration for a market-related rental payment.

Alternatively, an asset may be leased in consideration for certain future rental payments (or a single lease payment). In these cases, the benefits and risks associated with the ownership of the asset have been transferred to the lessee to some extent. In general, the longer the period for which future lease payments and other obligations under the lease are fixed, the greater the transfer of rights from the lessor to the lessee.

Where a lease is in substance a change in the ownership of the asset subject to the lease, the lease should be treated as a taxable disposal. The owner of the asset would recognise any income or loss in respect of the asset and the lessee would assume the asset's market value as its cost. The lessor would be deemed to have loaned the lessee an amount equal to the market value of the asset.

Existing income tax rules in relation to "specified leases" attempt to define leases that are equivalent to sales. These rules should provide a useful starting point in defining lease transactions that should be treated as taxable disposals. Existing specified lease rules should also be reviewed to ensure that income and expenditure derived or incurred by the lessor and the lessee are accrued correctly and that any gains or losses on the sale or termination of a lease contract are recognised when they are realised.

### **Sale of Leases**

A lessee may dispose of a lease in the same way that other assets are disposed of. Hence, profits or losses derived on the disposal of leases would be treated in the same way as other property.

#### **15.3.7 Security Arrangements and the Amalgamation of Titles**

Under the approach outlined above, the pledging of property by way of security for an obligation would not be treated as a taxable disposal since such an arrangement does not normally represent a significant transfer of the benefits and burdens of ownership. Similarly, the amalgamation of separate assets into one title should not be treated as a taxable disposal provided that the ownership interests in the assets do not change. For example, a taxpayer may arrange for the title of two separate properties to be amalgamated into a single title. This should not result in a taxable disposal, provided that the taxpayer's ownership interest in the amalgamated property does not differ from the sum of his or her previous interests in the disaggregated properties.

Similarly, the splitting of titles (e.g., the subdivision of land) should not give rise to a taxable disposal. A further example is a reduction in the par or nominal value of shares. This does not alter economic ownership and hence should not be treated as a disposal.

## 15.4 Involuntary Disposals

### **Destruction of Property**

Changes in ownership rights may occur by means other than a voluntary agreement between two parties. Involuntary disposals of property may occur either because of accidental destruction or because of the acquisition of property for public purposes (such as taking land to build a road). In either case, third party payments may compensate an individual for the market value of the property. If this occurs, the economic nature of the transaction would differ little from an actual sale of the property. If the transaction were treated as a taxable disposal, the amount of compensation would be treated as assessable income. The cost of the property would be deductible in the year the compensation is recognised.

This approach would be consistent with current practice with respect to trading stock and depreciable assets. In essence, assets which are destroyed are treated as being sold at a price equal to the insurance, compensation or damages received.

Public perceptions of fairness may, however, suggest that the involuntary destruction of personal residences should not be treated as a taxable disposal. In such cases, insurance proceeds are unlikely to compensate fully for all losses, including psychic and other costs associated with the dislocation caused by the involuntary disposal.

Other countries generally confer non-recognition treatment for income derived from the loss or destruction of property only if a similar replacement asset is acquired within a reasonable time. A problem with such restrictions is that they effectively lock taxpayers into certain asset types.

An alternative treatment would be to require that the owner of a destroyed house reduce the cost for tax purposes of one or more assets (including a replacement house, if acquired within a reasonable period) by the amount of the insurance proceeds or compensation received, provided that the cost of any asset does not fall below zero. The reduction in the cost of other assets held by the taxpayer ensures that the income not recognised on the destroyed property is eventually realised when the taxpayer sells other assets.

### **Compulsory Acquisition**

Compulsory acquisition of property is also an involuntary disposal. Hence, it could be argued that non-recognition treatment should apply. Examples are the compulsory acquisition of property for public works by local or central government or the compulsory acquisition of shares under rules that govern company take-overs. However, a non-recognition treatment of compulsory

acquisitions could create perverse incentives for taxpayers to resist reaching a negotiated settlement with the party seeking to purchase the property. In these circumstances, non-recognition could significantly distort such procedures.

A better approach would be to treat compulsory acquisitions as taxable disposals. If appropriate, private arrangements could be entered into whereby the purchaser compensates the seller for any losses the seller incurs from early recognition of income in respect of the property.

## **15.5 Related-Party Transactions**

### **15.5.1 Contributions of Property by Individuals to Entities**

In some cases, individuals contribute appreciated property to entities in exchange for an ownership claim in the entities and/or rights to future income. These transactions include contributions to partnerships, trusts, and companies.

The issue is whether, and in what circumstances, to treat such contributions of property as taxable disposals. If the transferor of property is a major owner or recipient of rights to income from the entity receiving the property, he or she retains an interest in the property, although the nature of that interest may have changed significantly.

To analyse the nature of the transaction, it is necessary to look through organisational forms and examine the net change in ownership rights.

### **Property Used in Joint Ventures**

A taxpayer may choose to permit an asset he or she owns to be used in a joint venture with other parties in consideration for a share of the gross or net income of the joint venture.

The extent to which this sort of transaction would represent a partial disposition of the asset by the taxpayer would depend on the specific terms of the joint venture. For example, the owner of the asset may be responsible for the costs of repairs and maintenance of the asset, or the terms of the joint venture may be able to be re-negotiated at the request of either party. These circumstances would imply that few, if any, of the rights to reap the rewards (or incur the costs) of any changes in the economic returns generated by the asset have been disposed of. The range of possibilities is, however, considerable.

Compliance and administrative considerations suggest that it would be impracticable to devise a rule to cater for all of these. Instead, as with leases, the more arbitrary approach may need to be adopted of defining the class of transactions that should be treated as disposals.

## **Contributions to Partnerships**

As noted in Chapter 2, there is some doubt over the treatment of transfers of assets to partnerships under current law. Such transfers are commonly considered to represent a partial disposition of the assets by the transferor to the partners of the partnership (i.e. the transferor retains an interest in the property contributed to the partnership). This view can be seen as being consistent with current income tax practice where, in general, partnerships are not treated as separate entities.

This approach suggests that contributions of assets to partnerships should be treated as partial dispositions. Rules might be necessary to ensure that contributions of property to partnerships could not result in a re-allocation of income among partners. That is, income or losses in respect of assets disposed of by a partnership should be treated as applying to the interests disposed of by each partner and should not be taken into account in the calculation of the net income or partnership loss of the partnership itself. There would, however, be considerable problems in tracing the interests of each partner in the assets of the partnership when it dispose of an asset.

An alternative approach is to view a partnership as the outcome of partners combining or pooling their property, where each partner has an equitable interest in each asset of the partnership. According to this view, the transfer of property to a partnership is a sale of the property to the partnership in consideration for a share in the net worth of the partnership. From the transferor's perspective, the nature of the exchange is that, before the transfer of property to a partnership, the transferor had title in the property transferred. After the transaction, the transferor has, in exchange, a proportionate share of the net assets of the partnership with the attendant benefits and burdens (including the assumption of contingent liabilities) that a share in a partnership implies. There has therefore been a fundamental change in the nature of the ownership interest held by the transferor. Moreover, since a partnership consists of more than one person, it is likely that the value of consideration in respect of the property transferred will accord with its market value (unless the other partners are persons otherwise related to or associated with the transferor).

These factors suggest that contributions of property to partnerships should be treated as taxable disposals since they represent changes in the ownership of property in exchange for consideration. They also suggest that partnerships should, in general, be treated as separate entities for tax purposes.

The Income Tax Act (particularly the rules in relation to special partnerships) has already blurred the distinction between the treatment of partnerships and companies. Special partnerships are, in effect, treated as companies when they are in tax loss and as ordinary partnerships when they derive net assessable income. All partnerships are treated as separate entities for the purposes of

the Goods and Services Tax Act 1985 and under the recently enacted resident withholding tax regime. For these and other reasons, Chapter 16 suggests that there would be advantages in treating partnerships as separate entities for income tax purposes generally.

If partnerships are to be treated as separate entities, transfers of assets to partnerships may have the objective of accelerating the recognition of losses without changing the substantive economic ownership of the assets. The recognition of the loss in such cases would be subject to a general anti-avoidance rule dealing with transfers between associated persons.

### **15.5.2 Contributions to Related Companies and Trusts**

The Income Tax Act treats companies as separate legal entities and trustees of trusts separately from both beneficiaries and settlors. The Act imposes obligations on companies and trustees to meet liability for tax on the income that derive. Special provisions prevent double taxation of individuals with claims to income from companies and trust.

Consequently, it is necessary to tax income derived from the sale of property owned by companies and trusts at the entity or trustee level where such income represents income of the company or trustee. As with other forms of income, taxation at the entity or trustee level will not result in double taxation. Double taxation is avoided with respect to companies by the imputation system. In the case of qualifying trusts, distributions of accumulated income that has been previously taxed to trustees are non-taxable in the hands of recipient beneficiaries.

### **Transfers to Companies**

As noted previously, the transfer of property to a partnership can be viewed as a sale of the property in consideration for a share in the net worth of the partnership. Likewise, the contribution of property to a company represents a sale of the property to the company in consideration for a share of the net worth of the company. Since the transfer represents a disposal of the asset for consideration (in this case in exchange for shares), the transfer should generally be a taxable disposal.

An exception to the full recognition of income on transfer is justified if the individual who contributes the property is the sole owner of the company. In that case, there has been no arm's length change in the economic ownership of the property because the original owner retains the full benefits and burdens of ownership through the wholly-owned company. Non-recognition treatment is therefore appropriate provided that suitable rules can be developed to prevent

this treatment being used for avoidance purposes. In particular, it would be necessary to ensure that income derived on the disposal of the property is recognised either when the asset is subsequently sold by the company or when shares in the company itself are sold.

For the same reasons, an exception to full recognition is also justified if assets are transferred from a company to an individual who wholly owns the company at the time of the transfer.

Rules similar to those that define an income interest in a controlled foreign company may be necessary to determine whether a company to which assets are transferred is wholly owned by the transferor.

### **Trusts**

Transfers of property to a trust represent a change in the ownership of the property because the transferor disposes of the beneficial interest in the settled property. However, property may be transferred to trust in which the settlor is a beneficiary.

There are a number of reasons, along the lines of those outlined above with respect to companies, why such transfers should be treated as a taxable disposal. Moreover, it is necessary to reduce the scope for trusts to be used for tax avoidance purposes.

### **Anti-Avoidance Rules**

As with transfers of property to partnerships, transfers between companies or trusts and associated persons need to be subject to anti-avoidance rules. For example, it may be appropriate to deem the sale price of assets transferred between associated persons to be at least equal to the cost of the assets. These rules should also apply in respect of property settled by a settlor on any discretionary trust or on a fixed trust in relation to which the settler is a beneficiary (or in relation to which the settlor is associated with a beneficiary).

The rules that determine when a person is associated with a company under the controlled foreign company provisions of the Income Tax Act provide a suitable starting point to develop rules for determining when a person is associated with a company.

#### **15.5.3 Inter-Company Asset Transfers**

The general rule that a taxable disposal should occur when ownership rights to property change among individuals should also apply to transfers of assets between companies. This means that a taxable disposal should result when one company purchases property from, or shares in, another unrelated company.

Asset transfers within a group of companies with common owners fall into a

different category. Section 191 of the Income Tax Act defines a "specified group" of companies as a group consisting of two or more companies in which the same shareholders hold all of the shares in each company in the same proportions. Under section 191, specified groups may elect to pay tax as a single entity. This treatment allows the netting of losses of one company in the group against profits of another. More generally, this treatment allows companies to use parent-subsiidiary or other group structures without tax consequences.

It is desirable to maintain this approach. Asset transfers within a specified group of companies are a re-characterisation of the form of ownership, but do not result in a change in economic ownership. Thus, the transfer of an asset from one company to another in the same specified group at the time of transfer should not be a taxable disposal. Suitable rules would need to be developed to ensure that income is recognised if the asset is either sold by the transferee company or shares in the company itself are sold.

In contrast, transfers of assets within ordinary groups (groups with more than 66 percent but less than 100 percent common ownership) should be treated as taxable disposals because these transfers result in a change in the economic ownership of the assets.

Once again, the above treatment would need to be supported by anti-avoidance rules. For example, Australia recently announced rules modifying the treatment of assets transferred between companies in the same group (Statement by the Australian Treasurer, 15 August 1989). Broadly, the rules restrict non-recognition to transfers of assets where the consideration is in the form of shares in the transferee company and the shares have a market value and indexed cost equal to those of the assets transferred. To prevent this rule resulting in the duplication of losses, non-recognition treatment does not apply where the asset transferred has accrued losses (i.e., it has a market value less than its indexed cost). Special rules also apply where the issuing of shares to a transferor company is prohibited by law, or where consideration is partly in the form of assumed liabilities in the asset transferred.

## **15.6 Bequests**

### **15.6.1 General**

The transfer of assets by gift or at death results in a change in ownership without the presence of an arm's length transaction.

The principal issue is whether to treat the transfer of assets at death as a taxable disposal or to allow non-recognition treatment (i.e., a "carry-over" of the property at cost to the transferee). The recognition of accrued income at death has significant economic advantages because it reduces the incentive to hold onto assets until death. It would also be in accordance with the general



rules under existing law where the disposal of property, such as trading stock or financial arrangements, upon the death of the owner give rise to a tax liability. Nevertheless, this approach would involve additional compliance and administrative costs and, for some asset transfers, raises equity concerns. The limited use of selected exemptions, non-recognition provisions, and loans from the Inland Revenue Department to the taxpayer can reduce some of these problems.

If the distribution of income from capital in New Zealand is similar to the distribution of this income in comparable Western economies, wealthy individuals hold a significant share of appreciating assets. Moreover, the levels of wealth accumulated by individuals are likely to be highest towards the end of a person's lifetime. These factors suggest that older taxpayers are likely to hold a significant share of appreciating assets with accrued but unrealised income.

In addition, the treatment of transfers at death or by gifting as taxable disposals results in a closer alignment between the effective tax rates on assets that generate income on disposal and those which generate assessable income over their economic life.

These factors, together with the likelihood that a significant proportion of the asset portfolios of older taxpayers consists of assets held for longer periods than would be the average among taxpayers, suggest that most of the efficiency costs of lock in would stem from lock-in effects for older taxpayers. If accrued income is subject to tax when assets are transferred by bequest, the lock-in effect for older taxpayers would be reduced substantially.

In many cases, the transfer of assets at death provides an opportunity for the valuation of assets and therefore facilitates measurement of the unrecognised income. A valuation of assets often occurs as part of the settlement of an estate. For example, some estates are currently valued for estate duty purposes. In those cases, the taxation of unrecognised income at death would not require the taxpayer or the Inland Revenue Department to make additional estimates of the value of assets.

In the light of the considerations outlined above, accrued income or losses should be recognised when assets are transferred at death.

### **15.6.2 Cash Flow Effects**

Recognition of income at death may cause cash flow problems for some taxpayers. This may be the case particularly if the accrued, but unrecognised income that the decedent leaves is a large fraction of the asset's total value and/or if the asset is not easily divisible. The second condition means that it may be difficult for the estate to raise the cash to pay the tax by selling a

portion of the asset.

This cash-flow problem could be alleviated by allowing a deferral of the payment of the income tax liability resulting from a taxable disposal at death. The deferred payment terms should include interest at a normal commercial rate.

### **15.6.3 De Minimis Provision**

Realisations at death would require taxpayers and the Department to undertake additional valuations and would therefore involve some additional administrative and compliance costs. In general, the efficiency improvement from treating transfers at death at taxable disposals are likely to outweigh these costs. There are, however, exceptions to this conclusion. In particular, a de minimis rule should apply so that valuations are not required for low value assets. To this end, there should be no taxable disposal unless the total value of the decedent's estate exceeds a certain threshold (say, \$100,000).

### **15.6.4 Estate and Gift Duty**

It should be noted that the taxation of unrecognised income at death is not an alternative form of estate duty. The unrecognised income is income in respect of which the decedent has not previously paid tax. In contrast, both the estate duty and gift taxes are separate taxes on the transfer of wealth. The base of the estate tax is total wealth transferred, less certain exemptions. This base is unrelated to the income tax base.

## **15.7 Gifts**

If unrecognised income is brought to account at death, it must also be brought to account when assets are given away. Otherwise, taxpayers would be able to avoid deemed disposals at death by giving away assets just prior to death.

Treating gifts as taxable disposals would involve some additional administrative costs. The Estate and Gift Duties Act currently exempts gifts below an annual threshold of \$27,000, although the Act requires disclosure of gifts in any year in excess of \$12,000. For gifts for which valuations are not currently required, costs would vary depending on how easy it is to value them. Valuation of some gifts, such as publicly-traded securities, will be simple. Valuation of other assets, such as shares in private businesses or personal assets, would be more difficult and subjective.

To reduce compliance costs, an exemption should apply to gifts of up to, say, \$12,000 in any year, the present annual exemption for gift duty purposes.

## **15.8 Transfers to Spouses**

Under current law, transfers of property between spouses pursuant to a matrimonial property agreement do not generally give rise to tax

consequences. This should continue to be the case. Hence, where property is transferred between spouses under a matrimonial property agreement, it should be deemed to be transferred for a consideration equal to the cost of the property in the hands of the transferor. Thus, the transferor would be deemed to dispose of the property for its cost.

Consideration should also be given to the allowing a comparable treatment for transfers from a parent or guardian to a dependent child where not doing so might cause undue hardship.

## **15.9 Transfers to Non-Taxable Entities**

People frequently donate assets to charities instead of donating cash. Once a charity has acquired an asset, future income from the asset is tax free. The income that the donor accrued before giving the asset to charity should, however, be assessable in the year the gift is made.

The donation of an asset to charity is equivalent to two separate transactions. The first is a sale of the asset by the donor in exchange for cash. The second transaction is a gift of cash to the charity.

For example, assume that a wealthy individual donates a painting worth \$100,000 to a gallery. Suppose that the indexed cost of the painting is \$75,000 and the tax rate is 33%. In that case, the disposal would add \$25,000 to the donor's assessable income and trigger a tax liability of \$8,250. The total sacrifice of wealth by the donor would equal the sum of the value of the painting after the deduction of tax (i.e. \$91,750, being \$100,000 less the tax of \$8,250).

Donors could require as a condition of the gift that the recipient institution pay them a cash amount sufficient to compensate for their tax liability. Donors would then be making a net gift equal to the difference between the deemed market value of the asset and the donor's income tax liability. Recipients would receive the property for only a small fraction of the total market price.

It is desirable that donors pay the same tax upon donation of appreciated property that would apply if they sell the property and donate the net-of-tax proceeds. To ensure this result, payments from a charity to donors to compensate them for costs associated with the gift should not be included in assessable income. This avoids double-counting the donor's income from the transaction. Assessable income from the transaction should depend only on the total market value and cost of the transferred asset.

The treatment outlined above is consistent with current law, where assets donated give rise to assessable income in the hands of the donor (e.g., under sections 90 and 91).

## **15.10 Assets Held by Trusts**

Trust may last for up to 80 years, or the length of a life in being at the time the trust is established plus 21 years. The opportunity is therefore open for taxpayers to settle assets on a trust and to allow income produced by the assets to accumulate within the trust for long periods. The recognition rules applying to gifts and bequests would thereby be avoided. It may therefore be necessary to deem unrecognised income on assets held in trust to be recognised within a specified time period (say, every 20 years). Alternatively, assets held in trust could be deemed to be disposed of when the settler dies.

Special rules may be needed in certain cases, such as for Maori authorities.

## **15.11 Emigration**

New Zealand residents can permanently avoid tax on some income by emigrating with unrecognised income. To prevent permanent exemption of this income, emigration from New Zealand should be treated as a taxable disposal. The treatment of taxpayers on emigration is discussed in Chapter 16.

## **15.12 Conclusion**

The diversity of ways in which assets can be transferred necessitates numerous rules to define which transfers should be treated as taxable disposals. The general criterion should be to treat transfers of assets that result in a change in economic ownership as a taxable disposal, subject to administrative, compliance, avoidance and equity considerations.

**PART IV: TRANSITION AND OTHER  
DESIGN ASPECTS**



# CHAPTER 16: OTHER DESIGN ASPECTS

## 16.1 Introduction

This chapter considers a range of issues that have not previously been discussed. These issues can be divided into three categories:

- issues relating to the integration of the main reform proposals (extension of the definition of income to include income on capital account and indexation of the tax system) with the existing income tax system. In that regard, the following areas are discussed:
  - implications for the rules on the deductibility of expenditure;
  - implications for the company tax system;
  - international tax implications; and
  - other integration issues;
- specific reforms that are relevant in the context of reforms to the income tax base and indexation. These includes reforms to:
  - the trading stock tax regime;
  - the taxation of partnerships; and
  - restrictions on expense deductions under sections 129 and 188A;and
- administrative details, including amendments to existing reporting and disclosure requirements, penalties, and the operation of the provisional tax system, which would be desirable in the light of the reforms outlined in this Document.

The main issues considered in this Document are base-broadening (bringing to tax previously untaxed income) and indexation (adjusting measured income for the effects of inflation). Both of these reforms could be achieved without the need to alter existing tax rules fundamentally.

Nevertheless, amendments to a number of other provisions of the Act would be desirable. Moreover, as noted in Chapter 2, some previous extensions to the tax base (such as sections 65(2)(e) and 67) have created a degree of uncertainty over whether losses are deductible, and if deductible, when. It would be preferable to avoid such uncertainty.

## 16.2 Expenditure Deductibility

There are a number of problems with existing rules on expenditure deductibility. For example, as outlined in Chapter 3, relative to many other similar countries, New Zealand has very few rules that require expenses to be capitalised so that income and expenditure are more appropriately matched. Nevertheless, such issues are not the focus of this Document.

Instead, consideration is limited to amending the existing deductibility rules to the extent that that is made desirable by the main reforms. The general structure of existing deductibility provisions could be retained.

### 16.2.1 Scheme of Current Deduction Provisions

Under existing provisions, section 101 of the Act denies a deduction for any expenditure or loss incurred unless the Act makes express provision elsewhere for such a deduction. Section 104 does make such an express provision, allowing a deduction for any expenditure or loss in the year that it is incurred to the extent that the expenditure or loss has a sufficient nexus with the assessable income. Section 106 then denies a deduction for expenditure or loss in certain circumstances, including:

- expenditure on capital account, except accrual expenditure - (paragraph (a));
- expenditure or loss considered not to have been borne by the taxpayer, being a bad debt that is not actually written off or an amount recoverable under any insurance or right of indemnity - (paragraphs (b) and (c));
- income tax as well as tax penalties and various forms of interest charged under income tax, land tax, stamp and cheque duty and estate and gift duty legislation - (paragraphs (f), (fa), (fb), (fc), and (g));
- private and domestic expenditure, including payments to a spouse other than bona fide payments for services to produce assessable income, the rental of a dwellinghouse, or a domestic office to the extent that the premises are not used to produce assessable income; and horse racing expenditure - (paragraphs (j), (d), (e) and (n));
- the production of income exempt from income tax, as well as interest and accrual expenditure that does not have a nexus with assessable income, and losses on premises or domestic offices except losses on disposal where any gain would be assessable under section 65(2)(e) or (f) - (paragraphs (k), (h)) and (l));



- superannuation contributions, or any retirement payments for employees - (paragraphs (m) and (n));
- a expenditure or loss for which a deduction has otherwise been made - (paragraph (o)).

This scheme for deductibility can be applied where the tax base is widened although, as discussed further below, a number of modifications to existing rules would be desirable.

### **16.2.2 Need to Clarify the Relationship Between Deduction Provisions**

First, there is some confusion over the interaction between sections 104 and 106. For example, it is sometimes argued that some of the provisions in section 106 restricting deductibility are unnecessary in that those restrictions are already implied in section 104. Moreover, there is some confusion over whether provisions in section 106 that provide for deductibility (such as deductibility of interest) are subject to the other provisions of section 106. It is assumed here that provisions in section 106 are generally subject to other restrictions in section 106. Thus, interest costs that constitute private and domestic expenditure should be non-deductible on the same basis as other private and domestic costs. Nevertheless, the law should be clearer on such points. The current reform exercise offers a useful opportunity to redraft the measures to achieve this.

### **16.2.3 Modifications to the Provision Barring Deductions for Capital Expenditure**

Secondly, amendments would be necessary to the above provisions in section 106 that restrict deductible expenditure. In particular, if income on capital account is to be assessable, expenditure on capital account should be deductible. However, it would not be correct simply to repeal section 106(1)(a), the paragraph barring a deduction for capital expenditure. That could allow taxpayers to deduct capital expenditure in full in the year that the expenditure is incurred. The result would be that taxable income would not reflect a taxpayer's true position, since expenditure on capital account is not a true loss to a taxpayer to the extent that the taxpayer acquires an asset with value. In other words, although the capital/revenue distinction is difficult to rationalise on the income side, on the expenditure side its retention in some form would be necessary to defer deductibility until economic losses are sustained.

Existing rules generally allow deductible expenditure or losses to be recognised in the year they are incurred, but an exception is normally made with respect to expenditure incurred in the purchase of property which may give rise to an assessable gain on realisation. In such cases, the legislation generally aims to

allow the deduction only in the year in which the property is disposed of (although normal depreciation allowances may be available). In other words, the expenditure is capitalised until the year of disposal.

Deferring recognition of expenditure until realisation of the property is equivalent to taxing such transactions under the trading stock regime but with trading stock valued at cost. As discussed in Chapter 12, the need for realisation-based recognition is largely the result of the valuation problems of a accrual based system. Reductions in the value of assets are recognised under depreciation provisions (where appropriate) or when the loss is realised when the asset is disposed of. Although this approach may fail to reflect the true income position of taxpayers, it is consistent with the rule that a gain on an asset is not recognised as income until the asset is disposed of. Overall, this rule produces a better matching of income and expenditure than would be the case if expenditure were recognised earlier. It would therefore be an appropriate method to adopt for the purpose of determining the timing of deductibility of expenditure incurred in producing income that would become assessable if the reforms proposed in this Document were enacted.

Although a capitalisation rule is reflected in existing law, it is not set out in current legislation. The result is that there can be disagreements and uncertainty over what the law actually requires. The appropriate rules should be clearly set out in the legislation. This could be achieved by retaining a provision along the lines of section 106(1)(a), but allowing a deduction in the year of disposal for expenditure incurred on assets for which any gains are assessable. Any expenditure on capital account which does not produce an asset producing realisable gains or losses would remain non-deductible. Such a rule could be extended in the future, as appropriate, to require expenditure producing long-term benefits (such as some advertising expenses) to be capitalised and amortised over time.

This approach of deferring deductibility of expenditure under a capitalisation rule would have the advantage of making it clear that income from the disposal of property is gross income, with the deductibility of expenditure separately accounted for under the appropriate provisions of the Act. As noted in Chapter 2, the present legislation is confusing as to whether the profit or gain to be taken into account is a net or gross amount. Gross income is more in accordance with the structure and scheme of the remainder of the Income Tax Act.

#### **16.2.4 Expenditure to be Deductible in Calculating Income or Losses on Property**

Another area of uncertainty in current legislation is the method of calculation to be used where an asset produces taxable income or deductible losses on realisation. General practice now is to deduct in the year incurred any

expenditure or loss on revenue account that is generally deductible under ordinary rules. The taxable gain on disposal of property is generally calculated by deducting from disposal proceeds:

- the costs of acquiring the property (acquisition price plus legal and other costs normally on capital account);
- any costs incurred in improving the value of the property that are not otherwise deductible; and
- any costs (that are not otherwise deductible) incurred in defending ownership of the property.

Thus, assume that a person purchases rental accommodation for \$100,000 in circumstances where any gain on resale is taxable under existing law. The property is held for two years. The taxpayer spends \$1,000 on legal and real estate fees, \$50,000 on improvements, \$28,000 on interest and rates, derives \$10,000 in rental income, spends \$5,000 on legal fees over a dispute as to title to the land, spends \$2,000 on repairs and maintenance and then sells the land for \$180,000. Depreciation on the property allowed as a deduction is \$1,000. Over the two year period, the taxpayer would have a net rental loss of \$20,000 calculated as follows:

Rental income	\$10,000
Interest and rates	(\$28,000)
Repairs and maintenance	(\$2,000)
	_____
Net taxable income (loss)	(\$20,000)

The \$20,000 loss would normally be deductible, subject to provisions such as sections 129 and 188A. The taxpayer would also have deducted as a rental cost the depreciation allowance of \$1,000 but this would be clawed back on sale. The net taxable income would be \$24,000 calculated as follows:

Sale proceeds	\$180,000
Acquisition cost	(\$100,000)
Legal and real estate fees	(\$1,000)
Improvements	(\$50,000)
Costs of defending title	(\$5,000)
	_____
Net taxable income (loss)	\$24,000

Where the taxpayer purchases property any gain on which is taxed and that is used in the interim entirely for purposes not normally giving rise to deductible expenditure (such as a residence), the position is less clear. The \$24,000 may still be taxable. However, no deduction would be allowed for other costs (interest, rates, repairs and depreciation) on the grounds that the expenses are for private and domestic purposes and the asset is not used in the production of assessable income so as to give rise to a depreciation allowance.

The above method of calculating a net gain from a property transaction is the appropriate measure from a policy perspective. Legislation should explicitly provide for such treatment to avoid uncertainty. The legislation should also provide for a clearer integration with depreciation provisions. It is sometimes argued that, under current law, a taxpayer can deduct a depreciation allowance and a net loss when the loss is realised. This would result in a double deduction - once as depreciation and once as a loss on disposal. It is not certain that section 106(1)(o) - the provision denying double deductions - prohibits such a result since it is arguable that the two sums for which a deduction is claimed are different items.

#### **16.2.5 Depreciation and Consequential Changes**

As noted in Chapter 2, the current depreciation provision in the Act (section 108) largely leaves depreciation to the discretion of the Commissioner of Inland Revenue. The indexation proposals would make it necessary for the depreciation regime to be legislated for more specifically (although, if desirable, rates of depreciation could still be determined by the Commissioner). This would have the added advantage of lessening the extent to which taxpayers are dependent on departmental discretions when their tax liability is determined.

Depreciation could be better integrated into the rest of the Act by treating it as an interim deduction that is subsequently adjusted on disposal of the asset. The provisions bringing disposal proceeds to tax would then be along the same lines as the base price adjustment mechanism under the accrual rules. One result would be that any gain over the book value of a depreciable asset would be taxable on disposal - that would include the clawing back of any excess depreciation allowance (as is the case now) plus any gain over and above that amount.

Section 106(1)(l), which denies a deduction for losses on the disposal of premises where any profit on disposal is not taxable, could be repealed.

#### **16.2.6 Bar on Deducting Private or Domestic Expenditure**

Minimal amendments would be necessary to the other paragraphs in the existing section 106 in order to accommodate an extension of the income tax base. Consideration would need to be given to the current rules on what bad debts written off should be deductible. As noted in Chapter 2, this is one area where the accrual rules retain a capital/revenue distinction. Where the accrual

rules apply, the legislation attempts to limit a bad debt deduction to amounts previously taxed unless the loan was made in the course of money lending activities. Consideration could be given to relaxing this restriction on bad debt deductibility in the light of further base broadening measures. On the other hand, the viability of any relaxation of existing rules would be dependent on ensuring that this did not allow a deduction for non-commercial loans, a measure that could provide a relatively easy means of shifting income from one taxpayer to another.

The denial of deductions for expenses or losses that amount to private or domestic expenditure would need to be retained. That is, income should be calculated prior to deducting any consumption expenditure, even if such expenditure may have an association with the earning of assessable income. Thus, people should not be able to deduct the normal costs of feeding, clothing and sheltering themselves on the basis that the expenditure is necessary to allow them to derive income from their labour.

The result would be that any expenditure or loss previously non-deductible at any stage because it was on capital account would remain non-deductible if the expenditure or loss was incurred for private or domestic purposes. This is the same rule that applies to any other form of expenditure or loss and is the reason for not allowing deductions for losses in the value of private cars and consumer durables. Depreciation and a realised loss on the disposal of a private residence arguably also constitutes private or domestic expenditure which would be non-deductible under normal income tax rules. This is because the house is used for private or domestic purposes. Normal housing expenses such as rates, depreciation, repairs and interest costs would also be non-deductible even if the final disposal resulted in an assessable gain. The treatment of personal assets was considered in more detail in Chapter 13.

The distinction between what is and what is not private and domestic expenditure has been a long-running problem in administering the Income Tax Act. This is particularly the case where expenditure can be claimed to be incurred partly for private or domestic purposes and partly for other purposes (such as business or investment purposes). In such cases, the Act allows expenditure to be apportioned between non-deductible private or domestic purposes and deductible purposes. However, appropriate apportionment formulae are never easy to devise. The Act itself provides little guidance, although in section 106(1) paragraphs (d) - payments to spouses, (e) - rental on dwellinghouses, and (n) - racing, of section 106(1) - can be considered attempts to define more particularly what is private or domestic expenditure in certain circumstances.

These problems are likely to become more acute with any significant extension of the income tax base, especially in relation to housing. A clearer statutory definition of what constitutes private or domestic expenditure would therefore be desirable, as well as guidelines on how expenditure should be apportioned.

One approach is to deem all expenditure of a certain kind (such as expenditure on a private residence) to be non-deductible to the extent that certain criteria are not met. For example, costs associated with private residences (other than the costs of acquiring and improving the residence) should be deemed to be non-deductible private or domestic expenditure to the extent that the expenditure is not an additional cost incurred as a result of the use of the residence in an income-earning activity. Holding the house to derive assessable income on disposal would not constitute the use of the house in an income-earning activity.

### **16.2.7 Impact of Indexation**

Indexation of the income tax base would be easily accommodated within the above rules for the deductibility of expenditure. Expenditure deducted in the year incurred would not need to be adjusted. Depreciation allowances and expenditure that is deductible only when an asset is disposed of would need to be adjusted for the effects of inflation. The method for doing so was outlined in Part II.

## **16.3 Design Aspects Relating to Shares and the Company Tax System**

### **16.3.1 Shares**

Under the reforms outlined in this Document, all real gains or profits derived on the disposal of shares would be taxable while real losses would be deductible. A number of special rules are, however, needed for shares and other assets where a person may acquire multiple units at a variety of prices.

#### **General Rule**

Because different parcels of the same type of share may be purchased at different costs, it is necessary to have a rule which links sales with particular purchases in order that the indexed cost of sales can be determined. A similar requirement exists at present for trading stock.

Two possible approaches are to deem the indexed cost of shares sold to be the average indexed cost of shares of that type, or to determine the indexed cost on a first-in, first-out ("FIFO") basis. If the real price of shares remained constant, the two rules would be equivalent. If, however, share prices rise in real terms, the FIFO rule would tend to bring income to account earlier than the average cost method. Similarly, if share prices fall in real terms, the FIFO method would allow earlier recognition of any losses. Thus, the FIFO method appears to be the more appropriate one.

Accordingly, it is proposed that the indexed cost of shares be determined on a FIFO basis.

## **De Minimis**

Where a taxpayer has only a small value of shares (say, less than \$5,000 in total market value), the costs of applying a FIFO rule may be excessive relative to the revenue involved. Taxpayers in this position will still need to record the cost and timing of their share purchases but a simpler system of determining the cost of shares sold may suffice. For example, taxpayers could have a discretion to determine which parcel of shares is sold.

## **Share Splits, Bonus Issues and Options**

A reduction in the par or nominal value of shares (i.e., a "share split"), the issuing of bonus shares or options to acquire new issues of shares may all affect the market value of shares without altering the economic position of existing shareholders. For example, a company may double the number of its shares on issue by making a one-for-one bonus issue. All other things being equal, the market value of the company's shares would halve following allocation of the rights to the bonus shares.

Since the shareholders in this case have suffered no loss (since the aggregate market value of their shares would be unchanged), it is obviously desirable to adjust the indexed cost of the original shares so that sales of shares following allocation of the bonus shares do not trigger a non-existent loss. In the example given above, the cost of the original shares would have to halve.

Options to acquire shares can produce similar results. For example, an option to acquire new shares at no consideration is equivalent to a bonus issue.

Where the par or nominal value of shares is reduced (i.e., there is a share split), or the holder of the shares is entitled to a bonus issue or an option to acquire additional new shares, the indexed cost of the taxpayer's existing shares should be pro rated over the expanded number of shares the person will hold as a result of the transaction. For example, if a person buys 1,000 shares at, say, \$2 each, and the shares are then subject to a one-for-one bonus issue, the person would end up with 2,000 shares. The cost per share would be reduced from \$2 to \$1. This is appropriate since the market value of the shares would approximately halve, matching the revised cost per share.

The amount, if any, paid to acquire the shares would be pro rated over the cost of the shares giving rise to the option entitlement. This would be the case if the shares acquired under the option are of the same class as the shares originally held.

Where a holding of one class of shares gives rise to an entitlement to acquire another class of shares or the same class of shares in the future, it is necessary to allocate the indexed cost of the existing shares (the "original indexed cost") over those shares and the new shares or options. In principle, the original

indexed cost should be allocated between the two classes in proportion to the market values of the two types of share. (Any amount paid to acquire or exercise the option to acquire the shares would also be added to the cost of the shares in that class in the year that the amount is paid.) Where, however, it is not possible to determine market values, a different approach would be needed. In the extreme, it might be necessary to allocate all of the original indexed cost to the last parcel of shares (in the same company) sold. This might be necessary where there is no practical basis for allocating the original indexed cost between two classes of share.

Where an option to acquire shares is sold, the proceeds would be assessable income in the year of sale while the amount, if any, paid to acquire the option would be deductible in that year.

In this case, the indexed cost of the original shares would not be adjusted because the options are sold.

If a bonus issue is a taxable bonus issue, the taxable value of the bonus issue is treated as a dividend. As outlined below, the taxable value of the bonus shares would be added to the original indexed cost for the purposes of determining the new indexed cost of the bonus issue inclusive number of shares held following the bonus issue.

### **16.3.2 Integration with Imputation System**

If the extension of the income tax base along the lines outlined in this Document were enacted, companies would be taxed on income that is not currently subject to tax. In addition, shareholders would be taxed on real gains made on the sale of shares. If the increased real value of shares results from increased retained earnings that have already borne tax at the company level, the result would, in the absence of any offsetting mechanism, be a double taxation of company earnings. Such a double tax impost would defeat the purpose of imputation and should be avoided. As discussed below, this can readily be achieved by integrating the extension of the tax base to include gains on shares into the existing imputation system.

The basic objective of imputation is to tax corporate income at the marginal tax rates of shareholders. In brief, this is achieved by enabling companies to allocate imputation credits (corresponding to the New Zealand company tax they have paid) to dividends or taxable bonus shares distributed to shareholders. Shareholders are taxed on the sum of the dividends (or taxable bonus issues) and any credits they receive but they are able to claim a tax credit equal to the amount of the credits received. If a company fully allocates its imputation credits each year, its entire taxable income would be taxed at the marginal tax rates of its shareholders. Taxable bonus issues provide companies with a mechanism for allocating credits without the need to distribute cash dividends.



The imputation system can be used to avoid double taxation resulting from taxing gains at both the company and the shareholder level. Companies will continue to be able to allocate to their shareholders credits for tax they have paid, including tax to be paid on income that is now exempt. If companies do not wish to pay dividends in order to allocate credits, they could, as now, make a taxable bonus issue.

Avoidance of double taxation would be achieved by allowing the taxable value of any taxable bonus issue (defined as the amount capitalised by the issue divided by the number of shares issued) received by a taxpayer to be added to the total cost of the same class of taxpayer's shares in the distributing company. The cost per share would then be determined by dividing the new total cost by the number of shares held by the taxpayer, including the bonus shares. At the same time, the market value per share would tend to fall because of the increase in the number of shares on issue. The issue of taxable bonus shares (to which credits are allocated) therefore ensures, by raising the cost per share and deflating the price of the shares, that there would be no double taxation on income derived by companies.

This approach is illustrated in the following simplified example.

### **Example**

#### **- Company level**

Assume that a company derives \$100 of taxable income and "distributes" this amount by way of a taxable bonus issue. The company would pay tax of \$33 with a corresponding entry in its Imputation Credit Account of \$33. It would make a taxable bonus issue of \$67 which, together with the attached imputation credits of \$33, would be a dividend in the hands of the shareholder. Total tax paid by the company on the income of \$100 is \$33.

#### **- Shareholder level**

Assume that the shareholder originally had 100 shares that had been purchased at the beginning of the year for \$100. The cost of the shares is therefore \$100, or \$1 per share.

The shareholder would receive 67 taxable bonus shares that, together with the attached credits, constitute a dividend of \$100. Tax on that amount is \$33 but the tax would be offset by the imputation credits of \$33. No tax is therefore payable by the shareholder on the taxable bonus issue.

The cost of the shareholding is adjusted by adding to the original \$100 cost the value of the taxable bonus issue. The new aggregate cost is \$167. The shareholder now has 167 shares. The cost per share is therefore \$1.

Since the number of shares on issue has increased from 100 to 167, but the net assets of the company have increased to \$167, the value of the shares would remain at \$1. If the shares were sold for that price, the taxable gain would be sale price less cost which, per share, is \$1 minus \$1. Thus, no taxable income would be derived from the sale of the shares.

#### Total

The income derived by the company is \$100. The tax paid is \$33. Although gains on shares would have become taxable, the use of the taxable bonus route ensures that no double taxation results.

Should the company not be taxed on the \$100 income because, for example, the income is by way of a gain on property that has not been realised, then, assuming share prices do not take into account future taxation consequences, the shareholder would be taxed on the gain in the value of his or her shares. When the gain is realised by the company, with a consequent company tax liability, the result appears at first sight to be that both the company and the original shareholder would be taxed on what is in effect the same income. However, this result is more illusory than real because the taxable bonus issue route can be used to remove the double tax effect. In these circumstances, the new shareholder would sustain a capital loss equal to the previous shareholder's capital gain. Since both the original and new shareholders will anticipate this, share prices should adjust to compensate the original holder for the value of the expected future tax benefit.

### **16.3.3 Treatment of Capital Profits on Winding Up**

Receipts that are not taxed at the company level and that constitute a "capital gain amount" distributed on the winding up of a company are presently exempt in the hands of shareholders, provided the detailed requirements outlined in Chapter 2 are met. This exemption preserves on the liquidation of a company the general exemption for income on capital account. To the extent that the exemption for income on capital account is removed, this exemption for distributions would cease to apply. However, the exemption would be retained for amounts that have already accrued tax-free prior to the implementation date of any change to the present exemptions.

### **16.3.4 Inter-Corporate Dividends**

As noted in Chapter 2, under section 63 of this Act, resident companies can pass dividends between themselves without tax being imposed on the dividends. This inter-corporate dividend exemption is not designed to be a concession. Rather, its purpose is to prevent the same income being taxed multiple times whenever income is transferred between corporate entities. Most countries have some system for preventing such multiple taxation. Australia, for example, taxes the inter-corporate dividend but then offsets that

tax with a rebate.

With the introduction of imputation, this consideration is no longer relevant. To the extent that dividends are credited, they would in effect remain tax free to corporate taxpayers because the company tax liability would be offset by the imputation credit. Conversely, to the extent that dividends are uncredited, companies receiving dividends would incur a tax liability. If, however, the dividend passed on to another company, the tax payable by the initial recipient would in principle enable it to fully credit the dividend. Hence, under the imputation system, additional company income tax would be payable on dividends if there were no inter-corporate dividend exemption, but there would be no multiple taxation.

In practice, the inter-corporate dividend exemption creates many problems. Since dividends are not assessable income, special provision is required to allow companies a deduction for interest on funds borrowed to invest in other companies (section 106(1)(h)(ii)). This section has opened up areas of potential abuse, creating conflicts between taxpayers and the Inland Revenue Department.

The exemption has also created problems with respect to the implementation of the imputation system. Companies can be set up to trap dividends on behalf of shareholders who wish to defer the receipt of dividends so as to defer the tax liability on the dividends. Excess retention tax ("ERT") is designed to hinder such dividend-trap companies. However, the ERT provisions are not wide enough to capture all dividend trap companies. At the same time, they have unintended effects on other companies.

Finally, the exemption provides avenues for companies to escape tax otherwise payable on income from the disposal of property as well as potentially enabling companies to create artificial deductible losses where losses on the disposal of shares are deductible. For example, a company could possibly have tax-free income derived by a subsidiary company distributed as a tax-free inter-corporate dividend, then dispose of the subsidiary for a deductible loss corresponding to the subsidiary's reduced retained earnings. Many other ways of avoiding gains of sale are made possible because of the exemption. The basic feature of all of them would be to convert income which would be taxable as a profit on the sale of shares into an exempt inter-corporate dividend.

Section 99(5) of the Act is aimed at some forms of this type of avoidance, which is generally referred to as dividend-stripping. However, that section is limited in scope. Where it applies, it deems dividend income to include any consideration received on the disposal of shares cum dividend which would have been received as dividends if the shares had not been disposed of. It is thus aimed at a limited form of avoidance where individuals sell shares rather than receive a taxable dividend.

Section 198 is a comparable provision aimed at dividend-stripping by share dealers and deems, in certain circumstances, dividends received by a share dealer to be part of the consideration received by the dealer on the sale of shares. Hence, this section overrides the inter-corporate dividend exemption by deeming the dividends to be consideration received on sale of shares.

Neither section 99(5) nor section 198 would be sufficient to overcome the problems caused by the inter-corporate dividend exemption. To address these problems, it would be necessary to either remove the inter-corporate dividend exemption or strengthen considerably and expand the present anti-dividend stripping provisions.

## **16.4 International Aspects**

The possible extension and indexation of the income tax base would have a number of potential implications in an international context.

With respect to the extension of the income tax base, the normal rules on when residents and non-residents are subject to New Zealand tax should apply where feasible. This has been the general approach adopted with respect to previous extensions of the tax base. With respect to indexation, non-residents should be subject to tax rules comparable to New Zealand residents to the extent that this is feasible and does not raise avoidance or compliance concerns.

### **16.4.1 International Tax Principles**

As noted in Chapter 2, New Zealand income tax law adopts a standard approach of taxing New Zealand residents on their world-wide income and non-residents on income that is sourced in New Zealand. In other words, New Zealand attempts to tax all income that is attributable to New Zealand on the basis that it is either derived by a New Zealander or derived from New Zealand. The economic rationale for this approach is twofold. First, the tax system should not favour investment by foreigners in New Zealand over the same investments made by New Zealanders. Secondly, it should not favour overseas investment by New Zealanders to the detriment of local investment.

Treating overseas and local investments by New Zealanders on an equal basis is generally known as "capital export neutrality". An alternative concept is that of "capital import neutrality" which maintains that New Zealanders investing overseas should be able to take advantage of any taxation advantages offered in the country in which they are investing. The result of adopting such a principle would be that the tax system would encourage New Zealanders to invest in lowly-taxed offshore jurisdictions in preference to New Zealand. In practice, few countries adopt the "capital import neutrality" principle to any significant extent. The principle has been explicitly rejected in New Zealand, as illustrated by the international tax reforms enacted in 1988.

The principle of taxing New Zealanders on their world wide income and of taxing income derived from New Zealand by non-residents is subject to practical constraints and to the need to integrate the New Zealand tax system with the tax systems of other countries. Practical constraints mean that some forms of income derived from New Zealand by non-residents are subject to a final withholding tax rather than tax calculated on net income in the normal manner. This is particularly the case for financial flows (interest, dividends and royalties), where the non-resident taxpayer may not have any physical presence in this country, thereby making it difficult to enforce taxation levied on income after it has been received by the taxpayer. A withholding tax can be a minimum level of tax, a final tax, or an interim tax collected with an adjustment on the basis of a final return.

The New Zealand tax system is integrated with the tax systems of other countries by way of the provision of a credit for overseas tax paid on overseas-sourced income by New Zealanders and by a system of double tax treaties.

#### **16.4.2 Taxation of Residents**

As explained above, under the ordinary rules of the Income Tax Act, New Zealand residents are taxed on their worldwide income. In principle, the same rules should apply to any receipts or gains that become assessable as a result of an extension of the tax base. Thus, for example, New Zealand residents should be taxed on income derived on the disposal of property located in other countries. If this were not adopted, there would be major incentives for residents to sell assets located in New Zealand and to acquire assets offshore.

A credit for any overseas tax already paid on foreign income should be available under section 293 of the Act. The section may need to be amended to make it clear that a credit is available where other countries tax such income under specific capital gains tax or other regimes separate from normal income tax, as well as where that income is taxable under normal rules.

Income from offshore sources would continue, in general, to be taxed under the same rules as apply to domestic income. As a result, offshore income should be indexed for inflation to the same extent as on-shore income. However, before enacting such a measure it would be necessary to ensure that it did not create significant avoidance opportunities.

#### **16.4.3 Taxation of Non-Residents**

The normal rule is that non-residents are subject to New Zealand tax on income that has a New Zealand source. Income that has a New Zealand source is set out in section 243 of the Act and includes:

- income from a business carried on in New Zealand;

- income from the ownership of any land or from the sale of any property situated in New Zealand;
- income from shares in or membership of any company resident in New Zealand;
- income from contracts performed in New Zealand;
- income from a business carried on outside New Zealand to the extent that the income consists of (b) or (c) above.

In general, these source rules appear to be adequate to cope with an extension of the tax base. It would, however, be desirable to clarify some aspects and, in particular, the question of what constitutes an asset situated in New Zealand and what constitutes the performance of a contract in New Zealand.

The appropriate approach is to levy New Zealand tax on income that is associated with this country, subject to the levying of tax being at least reasonably feasible. In the case of immovable property located in New Zealand, the issue is clear that income derived from the disposal of the property should be deemed to be sourced in New Zealand. Where the property is movable, it may not be practicable to tax the income it produces over any period of time when the property happens to be physically located here. An extreme example is a ship or aircraft. New Zealand could not realistically attempt to tax any increase in the value of a ship or aircraft while it happened to be passing through this country.

The approach adopted by other countries is, in general, not to tax non-residents on gains from movable assets (unless those assets are interests in trusts, partnerships, companies or fixed establishments of one kind or another) provided that the income is not deemed to be domestically sourced by another rule such as being from a business carried on or a contract performed in the country. This approach recognises the practical constraints countries have in taxing non-residents.

With respect to companies, New Zealand's existing source rules (section 243(2)(g)) would deem any gain on shares of a company resident in this country to be New Zealand-source income. Most countries relax this rule. In theory, the tax system should look through a company and tax shareholders on income to the extent that the income is attributable to company assets associated with New Zealand. However, it would be impractical to separately identify company income attributable to New Zealand assets and then impute that income to non-resident shareholders.

A second approach would be to tax all income from shares in companies that are resident in New Zealand, but this would also be difficult to sustain. For example, it could result in tax being imposed on non-residents on income from the sale of New Zealand company shares purchased on an overseas market where the increased share value is attributable to an increase in the market value of overseas assets owned by the company.

Australia taxes income from shares in all private companies, as well as shares in public companies where the taxpayer and associated persons owned 10% or more of the issued share capital at any time during the five years prior to disposal. It is questionable whether the compliance and administrative costs of a 10% rule are justified by the tax it would collect. It may be easier to limit tax on gains derived by non-residents to gains on New Zealand company shares which are not listed on the New Zealand stock exchange. The rationale is that non-resident interests in non-listed shares are likely to be more substantial than interests in listed shares, thereby making enforcement more viable. Nevertheless, it would be necessary to ensure that adequate enforcement measures are available. Any non-resident deriving income from shares through a fixed establishment in this country would be taxable on the income on the same basis as a New Zealand resident.

With respect to interests in a trust or partnership, any gain should be taxable to non-residents if the property subject to the trust or held by the partnership has a New Zealand sourced. It may also be necessary to tax income from any interest in a partnership that is controlled from this country.

#### **16.4.4 Non-residents and Financial Arrangements**

Financial arrangements are subject to the accrual rules and thus will not be affected by any extension to the income tax base. Non-residents are generally exempted from the accrual rule provisions. The existing definition of income from a financial arrangement derived by a non-resident will not be affected by the measures outlined in this Document. In other words, where a non-resident derives tax-free income from a financial arrangement, the tax-free status of the income will not be affected by these measures.

#### **16.4.5 Consequences of Emigrating and Immigrating**

Chapter 15 concluded that emigration should give rise to a taxable disposal to prevent taxpayers from permanently escaping tax on accrued but unrealised income by emigrating.

The Income Tax Act would require that emigrants include unrecognised income on assets that are not New Zealand assets, that are held on the date of emigration and that are not held by a New Zealand resident trustee as assessable income in their New Zealand income tax return for the year of emigration. Income would be assessed as if the assets held by emigrants had been disposed of on the date of emigration.

Where a person who was a non-resident becomes resident, some of the person's assets should be deemed to have been acquired at the time he or she becomes a resident. The assets should be deemed to be acquired at market value at the beginning of the income year in which the person became a New Zealand resident. Assets so treated would be those on which gains or losses are subject to New Zealand tax when held by residents but which are not subject to New Zealand tax when held by a non-resident (i.e. where the income does not have a New Zealand source). This is the treatment that applies in countries such as Canada and Australia.

Statutory rules to give effect to these proposals would be required. Such rules would be along the lines of sections 64F(1)(d) and 64J(2) which apply to financial arrangements issued or held by emigrants or immigrants.

#### **16.4.6 Integration with the CFC and FIF Regimes**

New Zealand residents have in the past attempted to escape New Zealand tax on their income by investing in offshore entities. The recently enacted international tax reforms are aimed at preventing avoidance of tax by investment in certain companies controlled by residents (controlled foreign companies, or "CFCs") or through investments in certain other entities resident in tax haven countries (foreign investment funds, or "FIFs"). The mechanism is to tax residents on assessable income derived through such entities as it is earned. A similar approach applies to income accumulated in trusts settled by residents where the trusts have no resident trustee.

As a result of these rules, residents should not be able to avoid tax by accumulating gains in CFCs, FIFs or offshore trusts. Income derived through CFCs and FIFs that are resident in one of the seven countries on the "grey list"<sup>58</sup> are, however, largely exempt from the regime. Some of these countries provide concessions for income which might be included in the New Zealand tax base. It may therefore be necessary to qualify further the grey list to offset the effect of significant tax concessions which New Zealand does not duplicate.

CFC income would, of course, be calculated on the basis of the expanded New Zealand income definition. CFC income and FIF income would be indexed on the same basis as other income, subject to this not creating significant avoidance opportunities.

#### **16.4.7 Offshore Trusts**

No changes would be required to the trust regime except that the capital gain exemption for distributions from foreign trusts would be removed for gains accruing after the implementation date of the reforms. Practical difficulties would prevent any attempt to allow an indexation adjustment for any distributions from foreign or non-qualifying trusts.

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<sup>58</sup> (Australia, Canada, Germany, France, Japan, United Kingdom and United States.)



#### **16.4.8 Double Tax Treaties**

New Zealand's existing double tax treaties have been negotiated on the basis of a narrowly defined New Zealand tax base with no indexation for inflation. These treaties would need to be reviewed in the light of any changes made to the method of measuring and taxing income.

#### **16.4.9 Enforcement in an International Context**

Successful enforcement of an income tax depends on an effective system of penalties and an administrative system capable of identifying breaches. In addition, enforcement may be assisted by reporting requirements and/or by withholding taxes.

#### **New Zealand Residents**

It is possible for New Zealand residents to evade their tax liabilities by leaving the country and becoming non-residents without paying the tax liability due in New Zealand. The incentive for doing so could increase if a taxpayer has significant accrued tax liabilities from property gains unrealised until just before departure.

This type of evasion could be reduced by reminding emigrating residents of their liability for all outstanding taxes owed and requiring all New Zealand residents departing from or returning to New Zealand on a permanent basis to disclose certain information on their departure and re-entry forms. The Inland Revenue Department could use this information to determine whether a resident was absent from the country for more than 325 days. The Department could then investigate further to determine whether the taxpayer had become a non-resident and whether the taxpayer was subject to the tax on emigration.

While this type of reporting system would not prevent evasion by individuals leaving New Zealand on a permanent basis, it would remind emigrants of the requirement to file final tax returns and would assist the Inland Revenue Department in countering evasion by emigrants who have assets in New Zealand or who return to New Zealand, as well as companies that continue operations in New Zealand as non-residents. Information regarding whether a resident has travelled abroad would be useful also to the Department during an audit of a taxpayer in order to detect evasion of tax through sales of capital assets abroad.

#### **Non-residents**

If it is practical to implement, deduction at source is the best way of countering tax evasion. This is particularly true with respect to domestic-source income derived by non-residents.

Because a withholding agent will not normally have information regarding the seller's cost of property being sold, reporting or withholding could be done on a net basis only if sellers furnish information on the cost of the property sold to the withholding agent. If a seller fails to provide the information, the law could provide that the withholding agent must assume that the seller's cost is zero.

Canada taxes non-residents on domestic-source property gains using withholding procedures. The withholding rate is 30% (33% in 1990) on gross proceeds from sales of domestic-source assets realised by non-residents. Non-residents can obtain a certificate from Revenue Canada that permits withholding on a net basis if the taxpayer discloses information about the transaction. Similar withholding rules may be necessary in New Zealand to ensure that non-residents, especially non-residents who do not have any physical presence in or contact with New Zealand, pay tax on New Zealand-source property gains. A system such as this could not, however, be implemented without careful consideration of the compliance and administrative costs.

## **16.5 Other Integration Issues**

Extension of the tax base as outlined would allow certain specific provisions, such as sections 67 and 65(2)(e), to be repealed. Other integration issues are considered below.

### **16.5.1 Accrual Rules**

The accrual rules for financial arrangements provide for a "wash up" (i.e., the "cost basis adjustment") on realisation to capture gains that have not been taxed on accrual. Holders of financial arrangements, other than dealers who value financial arrangements each year for tax purposes, currently have the opportunity to realise losses and defer the realisation of gains. The deferral incentive is, however, minor. Consequently, it is not intended to bring the cost basis adjustment within the loss ring fencing provisions applying to some other property.

Transactions that are currently subject to the accrual regime but that are difficult to handle in that context (because the gains are not systematic) could be taken outside the regime and taxed under ordinary income tax rules once the income tax base is expanded. An example is a guarantee payment where the guarantor is not expected to be called upon to honour the guarantee.

### **16.5.2 Insurance Receipts**

Section 79 provides that insurance receipts in relation to trading stock and ancillary property are to be included in assessable income. For property that is brought within the tax net as a result of the removal of the current exemptions, the distinction in sections 117(7) and (8) between insurance receipts for reparable and irreparable damage will be applied. Receipts for

irreparable damage will be treated as a receipt for a disposal (or partial disposal) of the asset giving rise to a gain or loss as appropriate. This follows the current section 117(7). Where the receipts are for reparable damage, amounts in excess of the expenditure incurred in making good the damage should be non-assessable but subtracted from the property's indexed cost. Where the indexed cost falls below zero as a result, the excess insurance receipts would be assessable. This follows the logic of section 117(8). Where receipts for reparable damage are equal to or less than the expenditure incurred in making good the damages, the receipts should be assessable where the expenditure on repairs is deductible and non-assessable but subtracted from the indexed cost where the repair expenditure is non-deductible. As discussed in Chapter 15, an exception may be justified with respect to certain property, such as personal residences in some circumstances.

## **16.6 Reforms to the Trading Stock Tax Regime**

The main change that these reforms would require to the current method of taxing trading stock would be indexation, as outlined in Part II. However, the extension of the income tax base would also require that both the definition of trading stock and the rules relating to its valuation be re-examined.

### **16.6.1 Definition of Trading Stock**

There are three problems with the current treatment of trading stock. First, the definition of trading stock is too narrow. Under section 85 of the Act, the term "trading stock" includes anything purchased or manufactured, and anything acquired or purchased for the purposes of manufacture, sale or exchange, and also includes livestock, but does not include land or financial arrangements. The current definition thus omits some items, such as land, that would otherwise be trading stock in a developer's hands. This omission arguably allows developers to deduct expenditure on land and buildings in the year it is incurred, while any profits are deferred until the land and/or buildings are sold. It is therefore proposed to modify the definition of trading stock so that it can include land acquired for the purposes of sale.

Section 85 also exempts financial arrangements from the definition of trading stock. This is appropriate because such assets are subject to the accrual rules in sections 64B-M.

### **16.6.2 Valuation Rules**

The second problem with the treatment of trading stock relates to the valuation rules. Section 85 enables taxpayers, at their option, to value trading stock at its "cost price", "market selling value", or the "price at which it can be replaced".

Taxpayers will usually choose the option which gives the lowest value. This

means that reductions in the market value of trading stock can be deducted even though the stock is not sold and the loss may in fact never be realised. This treatment is asymmetric - taxpayers can accrue losses on trading stock but they recognise gains only when the stock is sold. In addition, since the closing trading stock of one year is the opening trading stock of the following year, any change in the closing trading stock of one year affects the income of that year in one way and the income of the next year in precisely the opposite way. Changes in the method of valuing trading stock consequently become a means of reallocating income from one year to another.

The valuation rules applying to trading stock should be amended to require a consistent method of valuation for similar items of trading stock. This would be comparable to the rules applying to livestock. Under this approach, a taxpayer would be required to adopt a uniform method of valuation for similar items of trading stock and would be able to change that method only by notifying the Commissioner in advance. In the case of livestock, taxpayers are able to change to a different basis of valuation only after giving notice at least one year in advance of the year in which the new basis is to apply. The same notification requirement should apply for trading stock other than livestock. This means that taxpayers would be able to elect to apply cost price, market value or replacement price to particular lines of stock and would not be able to change that basis of valuation except by giving at least one year's notice.

### **16.6.3 Assets Held as Both Trading Stock and Investments**

Some assets, such as company shares, may be held for investment purposes (in which case they would be treated in the same way as other investments) or as trading stock. At present, the boundary between these categories is difficult to administer satisfactorily. These difficulties would be compounded under the proposals outlined earlier in this Document since there would be an incentive to classify all assets subject to loss ring-fencing as trading stock so that the loss ring-fencing does not apply.

It is clearly not satisfactory to allow taxpayers the discretion to choose which treatment should apply. It is therefore proposed that taxpayers who may hold an item as either trading stock or as an investment (i.e., taxpayers who are dealers or traders in that type of asset) would be required to designate such assets, at the time they are acquired, as property other than trading stock if they are acquired for investment rather than for trading purposes. This designation would not be conclusive if the circumstances are such that the asset was in truth acquired as an investment.

This provision would not apply to financial arrangements. These are already subject to accrual treatment.

#### **16.6.4 Livestock and Bloodstock**

As outlined in Chapter 2, livestock and bloodstock are subject to a different tax regime from other trading stock. Amendments would be required to provide the same type of indexation proposed for other taxpayers with respect to trading stock. For livestock, no amendment would be necessary with respect to the herd scheme (section 86A) which is already in effect indexed. An indexation adjustment would be provided for those taxpayers operating under either the standard value scheme (section 86) or the cost/market/replacement value rules (section 86B).

High-priced breeding stock and bloodstock are treated as depreciable assets. Such livestock would therefore receive the same indexation adjustments as provided to depreciable assets generally.

### **16.7 Taxation of Partnerships**

The reforms outlined in this Document highlight an existing problem of integrating the current method of taxing partnerships with the rest of the income tax system. The present system, whereby partnerships are not treated as separate entities but, in essence, as joint ventures creates numerous difficulties. An example given in Chapter 2 is determining how assets moving into and out of partnerships are treated. Other problems arise with respect to partnerships with non-standard balance dates and difficulties of handling partnerships in an international context.

These problems could be dealt with by treating partnerships as separate entities subject to a residence rule and a partnership balance date, with recognition of income on disposals of assets when assets move in and out of the partnership (including partial disposals when partners change). The tax system could operate on a full integration basis with partners being taxed on their proportionate share of net partnership income at individual tax rates. Any net partnership losses should still be able to be passed through and offset against the other income of individual partners. In other words, partners would still be taxed on an individual basis as they are now, with returns being filed by both the partnership and the partners.

### **16.8 Sections 129 and 188A**

Under section 129 of the Act, a taxpayer is reassessed on interest previously allowed as a deduction on money borrowed to acquire rental land if the taxpayer sells the land for a profit within 10 years of the date of acquisition. Section 188A operates to restrict losses on such land to \$10,000 per annum per person. As noted in Chapter 3, these provisions were introduced in part to offset the narrow definition of income. Widening the base should allow for their repeal.

## **16.9 Administrative Details**

### **16.9.1 Reporting and Disclosure Requirements**

Existing reporting and disclosure requirements should generally be sufficient to handle any extension of the tax base and indexation system. However, taxpayers would be required to maintain records of assets potentially giving rise to a tax liability. The records would need to be maintained from time of acquisition until 10 years after the year the asset is disposed of and show:

- the date of acquisition, and who the asset was acquired from, or, if the asset was held at implementation date, its value at that date;
- the cost of the asset and the amount of expenditure on capital improvements;
- on disposal, the consideration received, the date of disposal, and to whom the asset was disposed.

Such records need be no more onerous to maintain than normal asset schedules for depreciation purposes. For residential houses, the schedules should not be necessary if taxpayers take advantage of the standard allowance for improvements. The house owner would only need to keep a record of the purchase price and sale price. Other adjustments could be made in the annual return for the year the house is disposed of.

### **16.9.2 Penalties**

Normal penalties would apply to taxpayers who failed to keep the required records or who filed false or misleading returns.

### **16.9.3 Provisional Tax**

Since tax on property gains would not generally be collected on a withholding basis, it would be included in provisional income. If unexpected income were to be realised at the end of the income year, interest charges or under-estimation penalties might result. Individuals earning under \$100,000 of provisional income and not paying provisional tax on an estimation basis would, however, face no interest charge on under-payments of provisional tax. Further, taxpayers deriving under \$1 million of provisional income are not required to pay provisional tax on an estimation basis.

## **16.10 Conclusion**

This chapter has reviewed the main subsidiary changes required to the tax system should the tax base be expanded and indexed. In general, these changes could be incorporated into the existing Income Tax Act with only relatively minor amendments to other aspects of the tax system. Thus, outside the areas where these proposed changes would have a direct impact, existing rules would require only relatively minor amendment.

# CHAPTER 17: TRANSITIONAL ISSUES

## 17.1 Introduction

The main transitional issue that needs to be resolved in respect of the reforms proposed in this document is how to treat currently exempt income and losses that are realised on the sale of assets that are owned on the day the reforms are introduced. Some of that income or loss may have accrued to the owner before the reforms are passed into law. While it is in the interests of economic efficiency to ensure that the reforms apply to all income and losses that asset owners expect to accrue after the implementation date (i.e., "prospective" income and losses), it is not necessary for the reforms to apply to income and losses that will have accrued prior to that date.

The second issue is how to introduce indexation of assets that are currently subject to tax. Both these issues are discussed in the following sections.

There are two possible approaches to restricting taxation of currently exempt income to prospective income and losses. One approach, which was used by Australia in implementing its capital gains tax, is to limit the application of the regime to assets acquired after the implementation date. An alternative approach, which was adopted by Canada and the United Kingdom, is to apply the reforms to all assets held on, or acquired after, the implementation date. This latter approach necessitates the introduction of special transitional rules for assets held on the implementation date in order to estimate the income or losses that have accrued to owners of the assets since that date. These alternative approaches are examined in the following sections with a view to determining which would be more appropriate.

## 17.2 Transitional Mechanisms

### 17.2.1 Limitation to Assets Acquired After the Implementation Date

Limitation of the reforms to assets acquired after the implementation date would guarantee that only prospective income and losses are affected by the reforms, since all of that income or those losses realised on the sale of those assets must have accrued to owners after the introduction date. However, in respect of assets held on the date of introduction, such a limitation would achieve this result at the cost of exempting from tax income that accrues and is realised after the commencement date. Such an approach might assist the introduction of the reforms by initially restricting their scope and later gradually expanding asset coverage as an increasing proportion of assets held

on the implementation date were sold and subsequently repurchased.

Exclusion of assets owned on the implementation date of the reforms would have a number of undesirable effects on economic efficiency and equity. In particular, this course of action would:

- exempt persons who hold assets on the implementation date from tax on any income they derive on disposal of the assets after that date and would prevent the deductibility of any losses. This effect is clearly inconsistent with the equity objective of the tax;
- create additional lock-in effects. Persons holding assets on the implementation date would have a greater incentive not to realise their assets. This lock-in effect would tend to impede the efficient operation of capital markets; and
- substantially reduce the revenue that would be raised by the reforms for many years and defer the corresponding efficiency improvements.

It is notable that both Canada and the United Kingdom rejected this approach when introducing their capital gains taxes. They chose instead to introduce special transitional rules to enable their regimes to be applied to assets owned on the implementation date as well as assets acquired after that date. These rules were intended to ensure that the regime applies only to gains or losses that accrue to the owners of those assets after the implementation date (i.e. prospective capital gains and losses).

### **17.2.2 Valuation Day Method**

Leaving aside for the moment the administrative and compliance considerations, the best approach would be to calculate income or losses derived on the sale of assets by reference to their market value on a particular "valuation day" - the day of the introduction of the reforms. This is comparable to the approach that has been followed in other recent reforms which have removed exemptions for certain classes of income (such as the international tax and superannuation reforms).

Under this approach, the cost of an asset for tax purposes is deemed to be its value on the valuation day. This cost basis is subtracted from all consideration received on the sale of the asset in order to estimate the amount of income or loss that has accrued to the owner since the implementation date. In essence, the valuation day method assumes that all assets are sold on the valuation day and then immediately re-purchased.

Although the valuation day method was employed for the purposes of introducing both the international and superannuation tax reforms, there are a number of problems associated with its use for the more general removal of exemptions proposed in this document:



- it would require a large number of valuations to be made (either on or close to the valuation day or, alternatively, at the time an asset is realised). For real assets such as land and buildings and for marketable securities (e.g. publicly-traded shares) the compliance costs involved in determining values on the valuation day would not be excessive. However, compliance costs could be considerable in determining the values of hard-to-value assets such as interests in private companies and assets that are infrequently traded. Existing valuation services are likely to experience particular difficulty when attempting to value these latter assets;
- it would not be possible to obtain accurate valuations for all assets subject to the regime. As a result, the application of the valuation day method might still give inaccurate estimates of the income or losses that have accrued since the implementation date. To the extent that taxpayers are able to inflate the valuation day values of assets, measured income on subsequent realisation of those assets would be understated. Inflating opening values would also exaggerate the amount of any losses subsequently realised. In either case, the tax base is eroded. In the interests of obtaining accurate asset valuations, it may be desirable not to announce the valuation day in advance.

Some of the compliance costs associated with the valuation day method, and the pressures it would place on valuation services, could be substantially reduced by not requiring asset owners to obtain a "valuation day" valuation of their assets for some period after valuation day - say until they are sold. However, this concession might increase the difficulty and costs associated with in due course obtaining an accurate valuation day value for those assets.

The scope for erosion of the revenue base under the valuation day method could be reduced by applying loss limitation rules to assets that are hard to value. For example, in the United Kingdom, the amount of any loss that is deductible under the valuation day method is limited to the lesser of:

- the difference between the actual cost and the sale proceeds; and
- the difference between the valuation day value and the disposal day proceeds.

Such a rule could be regarded as unfair (and would impose efficiency costs) in situations where the valuation day value imputed to an asset was accurate and was higher than its cost. Moreover, the rule could be avoided for easily traded assets by taxpayers selling and re-acquiring assets before the valuation day to establish a suitable cost.

If compliance costs of the valuation day method are considered excessive for some asset classes, asset owners could have the option of employing a "time apportionment" method (discussed in the following section) in relation to assets that are not easily valued. The combination of valuation day, loss limitation and the time apportionment is essentially the approach used in the United Kingdom. The application of such a simplified valuation rule to some assets held on the implementation of the regime may, however, have adverse effects on equity and economic efficiency by distorting owners' decisions as to when to sell those assets.

### 17.2.3 Time Apportionment Method

The "time apportionment" method assumes that any income or loss realised on the sale of an asset has accrued to the owner on a straight line basis over the entire period the asset has been owned. Given that assumption, it is then possible to estimate the proportion of the income or loss that accrued after the introduction of the regime using the following formula:

$$A = B \times C / (C + D)$$

where

A = the estimate of the income or loss that accrued to the asset owner after the implementation date;

B = the actual income or loss realised on sale of the asset;

C = the period of time between implementation date of the reforms and date of sale of the asset; and

D = the period of ownership of the asset prior to the implementation date.

The income or loss calculated using the above equation would, in addition, be adjusted to take into account expenditure on capital improvements and depreciation during the period the asset has been held.

As noted previously, the time apportionment method was one of the methods employed in the United Kingdom. Taxpayers were allowed to apply that method to all assets, other than listed shares and securities or land with development potential. A maximum limit of 20 years was placed on the number of years of prior ownership that could be taken into account for the purposes of the calculation outlined above (i.e. D was limited to 20 years). This was intended to eliminate some of the problems associated with determining when an asset has been acquired. By setting the maximum value of D in the above equation at 20, the rule also had the effect of placing an upper limit on the extent to which any income realised following the valuation day could be reduced.

The accuracy of any estimate of prospective income or losses obtained using this method obviously depends on the extent to which the time profile of the change in value of the asset in question actually matches the assumed straight line rate of annual growth or decrease over the entire period of ownership. As illustrated in Annex 17.1, if the value of the asset does not exhibit the assumed trend, application of the time apportionment method may either understate or overstate the income or loss accrued in the period following the implementation of the regime.

These estimation errors arise because the time allocation method averages the income derived on sale over the entire period of ownership. As a result, if for example the income or losses actually accrued in the years prior to the valuation day are greater than the income or losses accrued after that date, then the time apportionment method will tend to understate the income or losses accrued prior to that date, and overstate income or losses accruing thereafter.

Since few assets are likely to demonstrate a constant annual rate of growth, the time apportionment method is likely to mismeasure income derived (or losses incurred) after the introduction of the regime. It is therefore, in concept at least, inferior to the valuation day method.

Not only is the time apportionment method unlikely to yield accurate estimates of prospective income and losses on sale for assets that do not exhibit a straight-line rate of appreciation or depreciation over the entire ownership period, but it also would be difficult and costly to apply where:

- there are insufficient records of either the original cost (purchase price) or of any capital expenditure (i.e. on capital improvements) or depreciation incurred in relation to the asset since the date of purchase; and
- part of the asset has been disposed of prior to the valuation day.

Adoption of the time apportionment method would require additional rules to deal with these problems. Even where records are available, the separation of expenditure on capital improvements from revenue expenditure would involve significant compliance costs. It may therefore be concluded that the time apportionment method would be most effective in reducing compliance costs for hard-to-value assets in relation to which there has been little capital expenditure or losses and good records are available.

#### **17.2.4 "Median Rule" or "Tax-Free Zone" Method**

The "median rule" or "tax-free zone" method operates in a manner similar to the valuation day method in that it enables the taxpayer to determine a deemed cost of an asset held on valuation day. However, in this instance the deemed cost is the median (i.e. the middle) of three values:

- the cost of acquisition (adjusted for depreciation, partial sales and improvements);
- the valuation day value; and
- the proceeds on disposal.

The effect of the median rule is that income that has accrued to the owner of an asset after the valuation day is taxable only to the extent to which it has not been offset by losses that accrued prior to that date (and vice-versa in respect of the deductibility of losses incurred after the valuation day). For example, if the consideration received on the sale of an asset exceeds both the valuation day value and the original cost of the asset, then the realised income is determined by deducting the greater of cost or valuation day value from the disposal proceeds.

Conversely, if the disposal proceeds are less than both the cost of the asset and valuation day value then the loss realised in the period following the valuation day is determined by deducting the disposal proceeds from the lesser of the cost of the asset or its valuation day value.

However, if the disposal proceeds are between the cost of the asset and its valuation day value then none of the gain or loss realised on the sale of the asset is attributed to the period following the implementation of the reforms. The median rule in effect establishes a "tax-free zone" between the cost of the asset and its value on the valuation day. If the disposal proceeds fall within that zone, then none of the income or loss realised on the sale of that asset is deemed to have accrued to the investor after the valuation day. That is, unless the sale price of the asset is above both the original purchase price and the valuation day value of the asset, none of the income realised on the sale of the asset is assessable. Similarly, a loss is not recognised unless the sale price of an asset is below both its original purchase cost and valuation day value.

The median (tax free zone) method was employed by both the United Kingdom and Canada. The United Kingdom elected to employ the time apportionment method, except for assets that are easily valued (i.e. publicly-traded shares and securities and land with development potential). Owners of such easily-valued assets were given the option of employing either the valuation day or median rule methods. Similarly, Canada enabled individuals to employ either the valuation day or the median rule (tax-free zone) method, but companies were allowed to employ only the latter method.

The major advantage of the median rule method over the valuation day method is that it would not allow losses to be deducted to the extent of any unrecognised income which accrued before the implementation date. This is an

advantage for difficult to value assets because it would limit the extent to which losses could be artificially generated by excessive valuation day valuations.

In addition, of course, the taxpayer benefits to the extent of any unrealised losses at the time of implementation. Accordingly, it could be argued that any benefit to the taxpayer in not having future income taxed is balanced by a potential benefit to the Government in disallowing some losses, particularly where the opening value is artificially inflated by taxpayers. This symmetrical treatment may not always occur in practice, however. Taxpayers with unrealised losses at the time of introduction of the reforms will have an incentive not to realise such losses if they expect their assets will appreciate, since they would not be fully taxable on future income. Instead, income would be taxable only to the extent that they were not offset by prior losses. On the other hand, taxpayers with unrecognised income at the time of introduction of the reforms who think there is a chance that the value of their assets might fall would sell and re-acquire the same assets (or assets of a similar value) in order to crystallise a new cost. The result would be that future losses would be fully deductible. Such strategies would be easiest in relation to marketable securities but would be more difficult for assets where transaction costs of sale and purchase are high.

Among other disadvantages of a median-rule, such a rule would:

- result in a more complex and informationally demanding set of transitional arrangements. It requires most of the information required by both the valuation day and time apportionment methods. It is notable that both the United Kingdom and Canada provided taxpayers with simpler options to apply in circumstances where the assets concerned were likely to be difficult to value and where there were no records of the original cost of the asset nor records of any capital expenditure or depreciation incurred since the date of purchase; and
- introduce additional inefficiencies and inequities into the tax system by failing to recognise some of the income and losses the asset owner expects to accrue after the introduction of the reforms. This will distort the asset owner's decision as to when to sell the assets.

While the median rule would result in additional inefficiencies, these are likely to be significantly less important than those that would arise if the transition rule maintained an exemption for assets owned on the implementation date.

### **17.3 Transitional Provisions for Indexation**

The valuation day, time apportionment and median value methods could also be used to facilitate the implementation of inflation indexation of income that is realised on the disposal of assets. Each of these methods provides an

estimate of the appropriate cost of the asset on the implementation date of the reforms. This would be indexed for any subsequent inflation.

No special transitional provisions would be necessary to introduce the indexation of income from the sale of trading stock. Indexation of trading stock could simply be limited to income years commencing on or after the implementation date of the reforms.

The inflation indexation of depreciation allowances would also be relatively straightforward to introduce. For those depreciable assets that are held on the implementation date of the reforms, any subsequent depreciation allowances would be calculated on the basis of the depreciated book value of the assets on the implementation date. The exception to this rule is where the valuation day value of the depreciable asset is greater than its original cost. In that instance, any subsequent indexed depreciation would be calculated on the basis of an amount equal to the valuation day value of the asset, plus its depreciated book value on valuation day, less the original cost of the asset.

## **17.4 Conclusion**

Although it is in the interests of economic efficiency to ensure that taxation of previously exempt income apply to all income and losses that are expected to accrue to asset owners following the introduction of the reforms, it is not necessary for the reforms to apply to income and losses that have accrued prior to that date. Nevertheless, it is important to ensure that any approach employed to restrict the reforms to prospective income and losses has minimal adverse effects on economic efficiency and compliance costs. The economic efficiency argument implies that the reforms should apply to as much of the prospective income and losses as possible.

One approach that would ensure that the reforms applied only to prospective income and losses is to restrict the scope of the new rules to assets acquired after the implementation of the regime. Such an approach is, however, inconsistent with economic efficiency and equity.

A preferable approach to limiting the reforms to prospective income and losses is to apply the new rules to all assets held on, or acquired after, the implementation date and to introduce transitional rules for assets held on that date for the purposes of estimating the income or losses that have accrued to owners of those assets since that date.

Of the alternative transitional rules, conceptually the best is to value assets on "valuation day" - the day of the introduction of the reforms, and tax any income, or allow deductions for any losses, realised thereafter. This is comparable to the approach that has been followed in recent reforms such as the international tax and superannuation reforms.

However, it would be inappropriate to apply the valuation day method to all assets held on the implementation date of the reforms. The accuracy of the estimates of prospective income and losses obtained through application of the valuation day method is dependent on the extent to which it is possible to estimate accurately the valuation day values of assets held on the relevant day. Although it might be possible to obtain reasonably accurate valuation day values for a variety of assets such as land and buildings and marketable securities (e.g. publicly-traded shares), other assets such as interests in private companies and assets that are infrequently traded would prove difficult to value. As a result, application of the valuation day method to these hard-to-value assets would result in inaccurate estimates of prospective income and losses.

One possible solution to this problem is to employ a combination of transitional rules rather than to rely on the valuation day method alone. For example, the valuation day method could be restricted to easy-to-value assets and the time apportionment method could be applied to assets that are difficult to value. In comparison with the time apportionment method, the valuation day method is capable of providing more accurate estimates of prospective income or losses when it is applied to assets whose valuation day values can be accurately ascertained. However, this superiority is lost when the method is applied to assets that are difficult to value. In such circumstances, the time apportionment method may be capable of yielding an estimate of prospective income or losses that is just as accurate, while avoiding the compliance costs associated with the valuation day method.

Application of the valuation day and time apportionment methods would also facilitate the introduction of inflation indexation of any previously exempt income realised on the disposal of assets that are held on the implementation date of the reforms. Where income earned on such assets was previously taxable the existing book value on valuation day would form the cost for indexation purposes. No special transitional provisions would be necessary to introduce the indexation of income from the sale of trading stock. Indexation of trading stock could simply be limited to income years commencing on or after the implementation date of the reforms. The inflation indexation of depreciation allowances would also be relatively straightforward to introduce. For those depreciable assets that are held on the implementation date of the reforms, any subsequent depreciation allowances would be calculated on the basis of the written down book value of those assets on the implementation date indexed for any subsequent inflation. The exception to this rule is where the valuation day value of the depreciable asset is greater than its original cost. In that instance, the any subsequent indexed depreciation would be calculated on the basis of an amount equal to the valuation day value of the asset, plus its depreciated book value on valuation day, less the original cost of the asset.

## **ANNEX 17.1 COMPARISON OF TRANSITIONAL RULES**

### **Introduction**

This annex illustrates the effects of applying the valuation day, time apportionment, and median rule (tax free zone) methods to a range of assets the values of which exhibit a variety of trends over the ownership period in question (see Table 17.1). In all cases, accurate asset valuations are assumed.

### **Valuation Day Method**

Of the three transitional methods considered in this annex, only the valuation day method accurately estimates the income or loss that accrues all the assets following the implementation of the regime in year 3 (i.e. "prospective" income and losses). As indicated in the table, the time apportionment method provides accurate estimates of prospective income and losses for assets A and B only and the median rule method provides accurate estimates for assets A to F only. (This conclusion can be verified by comparing the estimated prospective income obtained using each of these transitional methods with the actual prospective income and losses).

Inaccuracies in estimates of prospective income and losses may arise, however, if the valuation day method is applied to assets that are difficult to value. One possible solution to this problem is to restrict the application of the valuation day approach to assets that are relatively easy to value and to employ the "time apportionment method" to assets that are more difficult to value. The accuracy of estimates obtained using such a simplified transitional rule is considered below.

A further complication arising from the application of the valuation day method is that it may result in the application of the regime to accrued income or losses that are not in effect "realised" on the sale of the asset since they are offset to some extent by losses or income that have accrued to the owner prior to the valuation day. For example, application of the valuation day method to asset H will result in taxable income of \$20, even though the owner of that asset realises a capital loss of \$10 on the sale of that asset. This result is entirely consistent with the objective of taxing only prospective income and losses. Both Canada and the United Kingdom employed the median rule (tax free zone) method in an attempt to avoid its apparent iniquities.

### **Time Apportionment Method**

The time apportionment method, assumes that any income or loss realised on the sale of an asset has accrued to the owner at a constant rate over the ownership period. The accuracy of any estimates of prospective income and losses obtained using this method is therefore dependent on the extent to



which the actual value of the asset in question moves in accordance with that assumed trend.

Consider first the estimates obtained by applying the time apportionment method to assets whose values conform to the assumed trend (A and B). These assets are initially purchased in year 1 for \$100 and later sold at the commencement of year 5 for \$140 in the case of asset A and \$60 in the case of asset B. The value of asset A increases at a constant rate over the entire ownership period (i.e. year 1 to year 5) whereas the value of asset B decreases. As a result, application of the time apportionment method accurately estimates the income that accrued to the owner of asset A and the loss that accrued to the owner of asset B in the period following the removal of the exemption in year 3 to be one-half of the \$40 of income or loss realised on the sale of the asset.

Now consider the accuracy of estimates gained by applying the time apportionment method to assets whose values do not conform to the assumed trend (i.e. assets C to J).

Assets C and E exhibit increasing values over the entire period of ownership, whereas assets D and F exhibit decreasing values. However, the rate at which their value increases or decreases is not constant. It changes after the introduction date. In the case of asset C (D), the rate at which the value of the asset appreciates (depreciates) falls after the introduction date, whereas in the case of asset E (F), the rate of appreciation (depreciation) rises. Application of the time apportionment method to asset C (D) will tend to understate the proportion of the income (loss) that accrued to the investor prior to the introduction date and overstate the proportion of the income (loss) accrued after that date. Conversely, application of this method to asset E (F) will overstate the income (loss) accrued prior to the implementation date and understate the income (loss) accrued after that date.

These estimation errors arise because the time allocation method averages the income accruing over the entire period of ownership. As a result, if the income or losses actually accrued in the years prior to the implementation date are greater (smaller) than the income or losses accruing after that date, then the time apportionment method will tend to understate (overstate) the income or losses accrued prior to that date, and overstate (understate) income or losses accruing thereafter.

So far we have only considered the application of the time apportionment method to assets whose values have increased (decreased) over the entire ownership period. In practice, however, some asset values are more likely to fluctuate over the period of ownership. Some of the effects of applying the time apportionment method to such assets can be seen by reference to assets G, H, I and J.

Unlike assets C and E (D and F), assets G and I (H and J) have not appreciated (depreciated) in value over the whole period of ownership. The owners of assets G and I (H and J) have accrued income (losses) in the period leading up to the introduction date and capital losses (income) thereafter.

In the case of asset G (H), the losses (income) accrued in the period after the commencement date have not been sufficient to fully offset the income (losses) that accrued up to the implementation date. Consequently, on the sale of asset G (H), the holder realises net income (loss) of \$10. However, in the case of asset I (J), the losses (income) accruing after the implementation date have more than offset the income (losses) that accrued prior to that date. Consequently, on the sale of asset I (J), the holder realises a net loss (income) of \$10.

Although the owner of asset G (H) has realised income (loss) on the sale of that asset, none of that income (loss) accrued to the owner after the implementation date. Since the implementation date, the owner of asset G (H) has in fact accrued losses (income) of \$20. However, application of the time apportionment method would result in one-half of the income (loss) realised on the sale of the asset being taxed (deductible).

Similarly, although the owner of asset I (J) has realised a loss (income) on the sale of the asset, the loss comprises only part of the loss that the owner has accrued since the implementation date. However, application of the time apportionment method would make only half of the loss (income) realised on the sale of the asset deductible (taxable).

In summary, unlike the valuation day method, the time apportionment method is unable to provide accurate estimates of prospective income or losses for assets C to J. That is, to the extent that accurate asset valuations can be obtained on the valuation day, the valuation day method may result in more accurate estimates of prospective income and losses for assets that have not exhibited a constant rate of appreciation or depreciation over the entire ownership period. Thus, although the application of the time apportionment method to assets that are relatively hard to value may reduce some of the compliance problems associated with the valuation day method, it may also tend to reduce economic efficiency by providing a less accurate estimate of the prospective income or losses that have accrued to the owners of those assets.

## **Median Rule (Tax Free Zone) Method**

The major apparent advantage of the median rule (tax-free zone) method over the valuation day and time apportionment methods is that income that has accrued to the owner of an asset after the implementation date is subject to tax only to the extent that it is more than offset by any losses that accrued prior to that date (i.e. "retrospective" losses). Conversely, any prospective losses are only deductible to the extent that they more than offset any retrospective

income. That is, the median rule method in effect ensures that prospective income or losses are only taxable or deductible to the extent that the taxpayer has actually realised income or loss on the sale of the asset over the entire ownership period. However, this advantage is achieved at the expense of an increase in administrative complexity as well as a decrease in economic efficiency.

For example, consider the effect of applying the median rule method to assets G and H. As indicated in Table 16.1, the owner of asset G has accrued income of \$30 in the period of ownership leading up to the introduction date, whereas the owner of asset H has accrued losses of \$30. After the implementation date, the owner of asset G accrues losses of \$20, whereas the owner of asset H accrues income of \$20. As a result, on the sale of asset G, the owner realises income of \$10, whereas the owner of asset H realises a loss of \$10. If the median rule method is applied to assets G and H, however, then none of the income realised on the sale of asset G would be taxable and none of the loss realised on the sale of asset H will be deductible. The reason is that the prospective losses and income accruing to the owners of assets G and H respectively are not sufficient to more than offset the retrospective income and losses that accrued to those owners prior to the implementation date.

Now consider the effect of applying the median rule method to assets I and J. The owner of asset I has accrued income of \$30 in the period of ownership leading up to the implementation date, whereas the owner of asset J has accrued losses of \$30. After the implementation date, the owner of asset I accrues losses of \$40, whereas the owner of asset J accrues income of \$40. As a result, on the sale of these assets the owner of asset I realises a loss of \$10, whereas the owner of asset J realises income of \$10. That is, in this instance the prospective losses and income accruing to the owners of assets I and J have been more than sufficient to offset the retrospective income and losses. As a result, application of the median rule method to these assets would mean that the owner of asset I would be able to only claim a \$10 tax deduction even though losses of \$40 had accrued since the introduction date, whereas the owner of asset J would pay tax on only \$10 of the \$40 of income that had accrued since the implementation date.

**Table 17.1**

<b>Year</b>	<b>Asset Value (\$)</b>									
	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>E</b>	<b>F</b>	<b>G</b>	<b>H</b>	<b>I</b>	<b>J</b>
1 (Purchase date)	100	100	100	100	100	100	100	100	100	100
2	110	90	115	85	105	95	115	95	115	95
3 (Introd. date)	120	80	130	70	110	90	130	70	130	70
4	130	70	135	65	125	75	120	80	110	90
5 (Sale date)	140	60	140	60	140	60	110	90	90	110
<b>Total Income or Loss Realised on Sale of Asset</b>	40	-40	40	-40	40	-40	10	-10	-10	10
<b>Actual Prospective Income or Loss</b>	20	-20	10	-10	30	-30	-20	20	-40	4
<b>Estimate of Prospective Income or Loss</b>										
- Valuation day method	20	-20	10	-10	30	-30	-20	20	-40	40
- Time apportionment method	20	-20	20	-20	20	-20	5	-5	-5	5
- Median rule or tax-free zone method	20	-20	10	-10	30	-30	0	0	-10	10

**Note**

For the purposes of Table 1 it is assumed that all assets are purchased at the commencement of year 1 and sold at the commencement of year 5. It is also assumed that the reforms are introduced at the beginning of year 3 (i.e., the first day of year 3 is the valuation day). The values in the tables are assumed to be the indexed values.

## **PART V: DIRECTIONS FOR REFORM**



# CHAPTER 18: DIRECTIONS FOR REFORM

## 18.1 Introduction

This chapter briefly summarises the conclusions of the earlier chapters of this Document and brings together the directions for reform previously outlined. The economic implications of the reforms are then summarised.

## 18.2 Summary of Policy Conclusions

### 18.2.1 Part I: The Present Tax System

#### Current Law

Under New Zealand's present income tax law, a wide range of "income on capital account" (including so-called "capital gains") is exempt from tax. This exemption is largely a result of historical developments by the courts. It is not related to the way people view investment decisions, nor is it related to the way they view their own economic position. Furthermore, the courts often find that the present boundary between taxed and untaxed income is extremely difficult to draw. One of New Zealand's leading judges has declared that drawing the boundary is "an intellectual minefield in which the principles are elusive and analogies treacherous".

For this reason, the original judicial distinction between taxed and untaxed income has been considerably modified over a long period of time by specific statutory provisions. For example, following legislative changes in recent years, there are now comprehensive provisions concerning the taxation of income from intellectual property and financial arrangements. Before these legislative changes, taxpayers could easily shift income across the boundary, thereby placing a disproportionate share of the tax burden on the shoulders of wage and salary earners.

Another important area where specific legislation attempts to bring income on capital account within the tax net is land transactions. The provisions in this area are, however, narrowly focused and produce anomalies between different taxpayers and different types of transactions. Outside these areas, the statutory provisions are generally weak.

Experience with these provisions indicates that taxing some forms of income on capital account while leaving other forms untaxed merely shifts the boundary between taxed and untaxed income. This creates problems on the new boundary. An example is the transformation of taxed land transactions into untaxed company share transactions.

The present stage of reform cannot therefore be regarded as optimal. The definition of taxable income still fails to include income that people are in reality deriving. The current rules are complex. They result in some taxpayers being over-taxed, others being under-taxed. Many opportunities remain for taxpayers to escape tax on the income they earn. Conversely, where the present law does tax income fully, it may overtax in periods of inflation.

The central issue is the extent to which the efficiency and equity of the tax system can be improved without imposing undue costs in terms of compliance, administration and complexity. This is the primary concern of this Document.

### **Problems With the Current Law**

The tax reforms over the past five years have considerably improved the fairness and efficiency of the income tax system. Nevertheless, there is room for further improvement.

In particular, two significant problems remain:

- the arbitrary and vague boundary between currently exempt income on capital account and other forms of income from capital that are taxed, in some cases, as a result of specific legislation; and
- the lack of any adjustment for inflation in the calculation of taxable income.

The exemption of certain forms of income on capital account undermines the fairness of the tax system and increases its costs. The exemptions discourage types of investment that would maximise growth and employment and they lead to uncertainty over the tax consequences of investments.

The lack of inflation-adjustment in the measurement of taxable income also increases the costs of the tax system and the extent to which it is regarded as unfair. Inflationary income as well as real income is taxed. Different types of assets are affected differently, thereby encouraging investment in one form of asset over another.

The tax system would be substantially improved if these two remaining major problems were rectified. There is no doubt that further worthwhile reforms that do not impose undue administrative and compliance costs are feasible.

#### **18.2.2 Part II: Real Income Tax**

Inflation increases the effective tax rate on income from capital, the more so the higher the rate of inflation. Returns on different forms of assets are affected differently so that, even if the tax system were neutral in the absence of inflation, it is not neutral when there is inflation. A move towards comprehensive indexation would reduce the effective tax rates on real income



and, more importantly, produce greater uniformity of effective tax rates, thereby improving the neutrality of the tax system.

Experience both here and overseas suggests that it is difficult to sustain the full taxation of nominal income from capital, even at low or moderate rates of inflation. Indeed, other countries have found it necessary to provide various forms of relief, such as investment allowances, accelerated depreciation, exemptions, roll-overs and concessional tax rates, partly to ameliorate the effects of inflation on real tax rates. In addition, a number of countries have overlaid these concessions with some form of inflation indexation. The resulting combination of concessions and indexation greatly complicates the tax system.

### **18.2.3 Part III: Removal of Exemptions**

#### **General Approach to Exemptions**

It is clear that the current exemption of income on capital account is a serious deficiency in the tax system. A number of arguments that are commonly advanced against reform of the present treatment have been addressed in this document and are summarised in section 18.4. None of these arguments can justify retaining the present set of exemptions. Accordingly, the general approach should be to remove the exemptions except where there is good reason for retaining them.

In view of the conclusions on indexation outlined in Part II, income on capital account would generally be indexed for inflation. That is, only the real income derived, rather than the entire nominal income, would be taxable.

#### **Timing of Recognition**

While the taxation of income from capital on an accrual basis has important efficiency advantages (in that it would significantly enhance neutrality and minimise lock-in problems), such a regime could not be administered effectively at the present time. Taxpayers would have considerable discretion in determining the values of hard-to-value assets. Consequently, the normal administrative system based on third-party reporting, audit and penalties could not be expected to be sufficient. In view of these considerations, income and losses on capital account would in general need to be recognised in the year that they are realised, rather than when they accrue.

A disadvantage of recognising income only when it is realised is that disposals of some forms of property are discouraged. This lock-in effect reduces the efficiency advantages of the reforms by inhibiting the transfer of property among taxpayers. Lock in is likely to be a particular problem where an

individual holds an asset for investment purposes; where sale and retention of the asset are regarded as closely substitutable alternatives; and where the value of the asset to the owner may change over time and diverge from its market value.

Overseas studies suggest that lock in will be significant if income derived on the sale of assets is taxed at nominal rates in excess of 25-35%. Arguments can be advanced for special measures to relieve lock in with respect to particular assets. When, however, such income is indexed for inflation, lock in is much less significant. In addition, any attempt to reduce lock in by providing tax subsidies would be inconsistent with the neutrality objectives of the reforms, give rise to boundary problems and pressures for further concessions and add to the complexity of the tax system. A better approach is to continue to pursue the dual objectives of broadening the tax base and lowering effective tax rates. The reforms outlined in this document are fully consistent with both of these objectives.

One consequence of the lock-in problem is that taxpayers have an incentive to defer the recognition of income while recognising losses as early as possible. To minimise this incentive, some categories of loss need to be ring-fenced. That is, such losses would be deductible only against certain specified forms of income.

### **Personal Assets**

The present tax system distinguishes between business and personal assets (such as personal residences, cars and boats). Personal assets produce non-monetary income (i.e., a flow of services which could be sold to earn monetary income but that are instead consumed by the asset owner). Because this non-monetary income is not taxed, the present tax system encourages more investment in these assets than would be the case under a more neutral system. The exemption of income derived on the sale of personal assets would accentuate this bias, push up the price of existing personal assets and lead to further over-investment in such assets.

Such an exemption would also be inconsistent with the equity objectives of the tax, since individuals with relatively high levels of income and/or wealth would benefit most. For example, home owners, particularly owners of high-priced homes, would be advantaged relative to those who rent.

Nevertheless, the historical data on house prices in New Zealand indicates that the average real rate of increase is small, at around 0.7% per annum. The compliance costs of accurately measuring small real gains would, however, be large since most home owners are not accustomed to keeping detailed tax records. In order to minimise additional compliance costs without introducing the problems that complete exemption would involve, taxpayers will be able to add an indexed standard allowance (of, say, \$4,000) to the cost of their

principal residence. Any profit on sale, after adjusting for the effects of inflation, would be measured relative to the sum of the indexed acquisition cost and standard annual allowances. Where a taxpayer chooses not to apply the standard allowance, the actual expenditure on capital improvements (rather than the standard allowance) would be added to the cost of the residence.

The standard allowance approach will ensure that most homeowners would pay little, if any, tax on the sale of their principal residence.

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 deductible on the basis that they represent expenditure or loss of a private and domestic nature. If income derived on the sale of houses and appreciating personal assets were assessable but the non-monetary (i.e., imputed rental) income they produce remains non-assessable, the deductibility of expenditure or losses in relation to these assets would worsen the present tax bias because the bulk of the income produced by personal assets is in a non-monetary form. Hence, both the present tax law relating to expenditure of a private or domestic nature and the weight of economic argument supports the continued non-deductibility of expenditure or losses incurred in relation to houses and other appreciating personal assets.

Some 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. The deductibility of these losses, in addition to the continued exemption of the non-monetary income they produce, would accentuate the tax bias in their favour. Personal assets that depreciate should therefore continue to be excluded from the tax system.

#### **18.2.4 Part IV: Other Issues, Integration and Transition**

##### **Other Issues**

The taxation of income on capital account, after allowing for the effects of inflation, will necessitate a relatively minor change to the present imputation system in order to ensure that when income is derived by a company it is not taxed at both the corporate and shareholder levels and that the benefits of indexation at the corporate level are preserved in the hands of shareholders.

The taxation of income on capital account derived by companies on the sale of shares is complicated by the intercorporate dividend exemption. In effect, this might enable companies to convert taxable income into exempt dividends. From one perspective, such conversion merely raises the tax liability ultimately borne by the company's shareholders when they sell their shares

Nevertheless, the payment of tax is deferred and the benefits of withholding at the corporate level are lost. To minimise the scope for this type of activity, it would be necessary to review and, if necessary, strengthen the present anti-dividend stripping measures.

Residents should be taxed on income on capital account irrespective of whether it is derived from New Zealand or other countries, with appropriate allowance for tax paid, if any, on that income in those other countries.

Principles of international taxation suggest that New Zealand should tax non-residents on income on all income from capital that they derive from New Zealand. There are, however, definite practical constraints on the extent to which New Zealand is able to tax this form of income when it is derived by non-residents.

Income derived by non-residents on the sale of property located in New Zealand should generally be assessable. Similarly, non-residents should be assessable on income derived from the sale of shares in New Zealand resident companies. There are, however, considerable administrative difficulties in taxing non-residents on income from the sale of shares. To minimise these problems, it is proposed that profits derived by non-residents on the sale of shares in companies listed on the New Zealand stock exchange would not be assessable in New Zealand. Profits from the sale of unlisted companies would be assessable, although further consideration needs to be given to enforcement procedures.

Some modification to the valuation rules for trading stock is desirable to ensure that there is greater consistency of treatment of stock that has risen in value or fallen in value.

It would also be desirable to modify the taxation of partnerships. The present rules that apply when assets are placed in a partnership or when partners change are unclear. The preferred approach is to treat partnerships as entities separate from the partners when calculating taxable income. However, partners should still be able to offset partnership losses against their other income.

Any reforms need to be supported by appropriate disclosure and reporting requirements.

### **Integration**

In general, the reforms outlined could be incorporated into the existing Income Tax Act with only relatively minor amendments to other aspects of the tax system.

### **Transition**

From an economic efficiency perspective, it is necessary to tax all income that accrues after the introduction of the reforms, whether it relates to assets acquired before or after the introduction.

For assets that are easy to value, the best approach is to measure income relative to the estimated market value of the assets on the implementation date. This is referred to as the "valuation day" method. Where an asset is difficult to value, an alternative approach would be to prorate the income or loss (measured relative to the original cost of the asset) realised on its sale according to the proportion of the asset's holding period that falls before and after the implementation date. This approach is referred to as the "time apportionment" method.

## **18.3 Summary of Desirable Reforms**

### **18.3.1 Indexation**

Chapter 10 of Part II of this Document sets out a range of reforms relating to indexation of income from capital. Of the proposed indexation measures, the indexation of interest appears to be the most complex. Ideally, interest income would be indexed as well as income realised on the sale of assets, depreciation allowances and trading stock. Correspondingly, borrowers would be allowed to claim a deduction for only the real component of interest expense.

Indexation of interest does, however, give rise to some potential tax avoidance concerns. It would not be possible to index interest unless it could be shown that this would be possible without undue complexity and without opening avenues for avoidance. If indexation of interest does not prove to be feasible, it would be necessary to restrict inflation indexation to the income produced by physical assets.

Provided that the indexation of interest can be implemented without undue complexity, Chapter 10 proposes that:

- income realised on the disposal of physical assets should be indexed by inflating the original cost of the asset and any subsequent capital expenditure for the effects of inflation. Taxpayers owning such assets would be able to adjust the income derived on their disposal for the effects of inflation that has occurred in each full quarter since the purchase of the assetS;
- income from the sale of trading stock should be adjusted for inflation. Taxpayers would be allowed to deduct the average value of stock multiplied by the inflation rate. Tax payers with average stock levels below a specified threshold (eg \$1 million) would calculate their average value of stock by taking a simple average of opening and

closing stocks. Taxpayers above that threshold would be required to calculate an average of their quarterly stock levels. In addition, as noted in Chapter 6, closing stocks would have to be valued in end of year dollars;

- depreciation allowances should be calculated on the basis of the indexed, rather than historical cost, book value of depreciable assets;
- interest income and expense would be indexed so that only the real component of interest income would be assessable. Conversely, only the real component of interest expense would be deductible.

### **18.3.2 Removal of Exemptions**

Part IIIB of the document sets out the main features of desirable reforms to the tax treatment of income on capital account. In brief, Part IIIB proposes that:

- currently exempt income on capital account, including in particular income derived on the disposal of property that is not currently taxable, should become taxable;
- expenditure incurred to acquire property and expenditure on capital improvements to the property would be deductible in the year the property is disposed of;
- 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;
- income or loss derived on the sale of property should be indexed for inflation;
- such income should be recognised when the property is disposed of;
- sales of depreciable personal assets such as household appliances, furniture, cars and boats should not be included within the tax net. This exemption should, however, not apply to income derived on the disposal of appreciating assets (such as antique furniture, vintage and rare cars, works of art, jewellery or collectables such as stamps and coins), subject to provisions to minimise compliance and administrative costs;

- income or losses derived on the sale of principal residences should be recognised for tax purposes, after removing 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 houses. This bias has increased the size of the housing stock and 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 that a residence is sold. This mechanism would ensure that sales of most ordinary houses would not give rise to a tax liability;
- expenditure or losses relating to personal assets should continue to be non-deductible, even where assessable 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. Under current income tax law, such expenditure or losses would generally not be deductible because it is expenditure or loss of a private or domestic nature;
- 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 income recognition when property is disposed of by a person to a company that 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 taxable 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-source income. New Zealand source income would be defined to include income derived on the sale of property 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 in which 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. This would ensure that currently exempt income or gains that accrue before the implementation date would not be taxed. Where property is difficult to value, the portion of the income or loss recognised should be estimated by prorating the actual income or loss, measured relative to the cost of the property, according to the proportion of the time it has been held that falls after the implementation date;
- a number of types of transactions or events, other than arm's length sales, are in substance changes in ownership and are thus 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 pursuant 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 should generally be treated as a taxable disposal. To support this rule, gifts should 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;
- one or more anti-avoidance rules would be needed; and
- disclosure and reporting requirements would be necessary.

### 18.3.3 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 also 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 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 partnership assets; and
- sections 129 and 188A should be repealed.

## **18.4 Summary Comment on Economic Effects of the Reforms**

### **18.4.1 Indexation**

#### **Effect on Neutrality**

Under the present income tax system, effective tax rates on real income from capital increase above the statutory rates when there is inflation. The increase is significant even at low rates of inflation. More importantly, the effects of inflation are not uniform across different asset classes. Broadly, the effective tax rates on income from the sale of trading stock and financial arrangements are most affected by inflation, while income from non-depreciable assets is not affected. The income from depreciating assets is affected to varying degrees depending on the rates of depreciation. Because of this non-uniform impact, inflation would undermine the neutrality of the tax system even if it were neutral in the absence of inflation.

In the past, accelerated depreciation and investment allowances have been introduced partly to reduce the adverse effects of inflation on investment. These measures are, however, far from perfect in that they do not systematically address the problems caused by inflation and inevitably worsen, rather than improve, the neutrality of the tax system.

Indexation of physical and financial assets would improve the neutrality of the tax system.

#### **Compliance and Administrative Costs**

The indexation of depreciation and property which produces assessable income on disposal should be relatively straightforward. The indexation of trading stock and financial arrangements would, however, be more complicated.

Business taxpayers, in particular, should have little difficulty with the indexation of physical assets. Non-business taxpayers, however, such as home owners, are not presently required to keep detailed records and would experience greater compliance difficulties. These difficulties should, however, be avoided for most taxpayers by the proposed standard annual allowance for principal residences.

The indexation of financial arrangements is more complicated because of the diversity of types of arrangements.

### **Relationship to Anti-Inflation Policy**

The indexation of income from capital for tax purposes would not in any way lessen the Government's determination to eliminate inflation. Indeed, under an unindexed system, governments benefit from inflation by way of higher tax revenue. An objective of raising revenue may therefore directly conflict with the objective of reducing inflation.

The Government remains firmly committed to its goal of reducing the inflation rate to a level of 0-2% by the end of 1992. Any decision to move towards an indexed tax system should be seen as reinforcing that commitment.

### **Revenue Impact**

Indexation of income from capital would reduce tax revenue because the taxation of inflationary gains would be curtailed. Any estimates of the revenue impact must of necessity be tentative given the number of assumptions that must be made regarding, in particular, the precise form of indexation and the future rates of inflation. A preliminary estimate suggests that comprehensive indexation of physical and financial assets would reduce tax revenue in the year of introduction by approximately \$300-400 million at current levels of inflation. This cost could fall as the inflation rate falls.

Because of the revenue consequences of indexation, it is desirable from the Government's perspective to introduce indexation during a time of low inflation. Hence, the present discussion of indexation does not indicate that the Government expects inflation to increase. On the contrary, indexation is canvassed now because the Government is confident that inflation is under control.

## **18.4.2 Removal of Exemptions**

### **Effect on Neutrality**

The exemption of a wide range of income on capital account means that taxpayers have an incentive to invest in assets or activities which generate this form of income. Investment in housing, land and buildings and other assets

which can produce untaxed income on sale is therefore higher than it would be under a more neutral tax system. Conversely, investment in activities which generate taxed income, such as manufacturing, processing and retailing, is lower than it would be under a neutral tax system.

Consequently, New Zealand is poorer than it would otherwise be because investment has been directed towards the wrong areas. Investments which, in commercial terms, would be best for the country as a whole have been displaced by investment which is less profitable to the nation but more profitable to the investor because of the tax subsidies provided by other taxpayers. It is obvious that New Zealand's wealth cannot be increased by giving one group of taxpayers a tax subsidy which is paid for by higher taxes on another group.

There are many examples of these effects in New Zealand. For example, there was considerable investment in the kiwifruit industry during the 1970s and early 1980s, much of which was motivated by the ability of investors to write off the cost of development expenditure. An early effect was that the price of land suitable for kiwifruit rose sharply, as did the cost of inputs to kiwifruit farming, such as the cost of the vines, frames and other infrastructure. As the production of kiwifruit increased, both in New Zealand and overseas, the price at which it could be sold decreased. This combination of rising capital and operating costs and decreasing returns has now meant that new investment in kiwifruit is no longer especially attractive. Indeed, land used for kiwifruit production is now being converted to other uses, such as dairying.

The consequence for New Zealand as a whole is that we have too much investment in kiwifruit production at the cost of too little investment in better-returning investment which did not have the same tax advantages.

### **Effect on Fairness of the Tax System**

The main beneficiaries of the present exemptions tend to be higher-income people because they have the resources to take advantage of them. As noted in the previous section, however, asset prices adjust such that part or all of the benefits of tax exemptions are eroded. In other words, the demand for assets which produce untaxed income pushes up their price and induces an increase in their supply, tending to reduce the returns that they generate. Once this adjustment process is complete, investors in tax-favoured assets probably derive no higher return that they would have derived from investment in other areas.

Nevertheless, even if all of the benefit of tax concessions is eroded, they may appear to many people to undermine the fairness of the tax system. Perceptions are important because the tax system relies for the most part on taxpayers voluntarily complying with it. If taxpayers perceive the system to be unfair, compliance problems and evasion are likely to increase.

The removal of the present concessions for income on capital account should improve the perceived fairness of the tax system.

### **Compliance and Administrative Costs**

Any reforms contribute to an increase in compliance and administrative costs because taxpayers and IRD must implement the reforms. This may require additional record-keeping, new administrative systems, additional personnel and so on. It is clearly important to attempt to minimise these additional costs.

The present exemptions for income on capital account do, however, involve heavy administrative costs for IRD because the distinction between taxed and untaxed income is so hard to administer. For example, IRD must inquire into the purposes of taxpayers at the time they acquire assets. A taxpayer's purpose is not directly observable, but must be inferred from the taxpayer's behaviour and other circumstances. Though this is capable of objective inquiry, it is very costly to do so. Consequently, the administrative costs borne by the Department would be significantly reduced if there were a more straightforward way to determine whether a profit on the sale of property is assessable. This would be the case under the reforms outlined in this Document.

Because the Department faces prohibitive enforcement costs in many cases under current law, taxpayers may frequently be given the benefit of the doubt. Nevertheless, taxpayers may still need to obtain expert advice on whether or not a particular transaction gives rise to ordinary income or income on capital account. In particular, taxpayers face costs similar to those incurred by the Department if they are the subject of an investigation and possible court action. Hence, the present exemptions impose costs on taxpayers as well as IRD.

While the reforms proposed in this Document would have the advantage of reducing these costs, other compliance costs would increase with the removal of the exemptions because income which is now untaxed would have to be returned.

### **Effect on Savings and Investment**

An income tax reduces the incentive to save and invest because it reduces the returns to savers and investors. The extent of the reduction, and hence the disincentive to save and invest, increases as tax rates increase. This effect could be avoided entirely only by abolishing income tax. Since this is not practical, the feasible policy options are concerned with ways of minimising the disincentive effects of an income tax. The major avenue for achieving this is to reduce rates of tax.

For this reason, one of the major thrusts of the Government's tax reform programme has been to broaden the tax base and lower tax rates. The removal of the current exemptions for and the indexation of income from capital are fully consistent with this approach.

In combination with comprehensive indexation, the removal of the exemptions would lead to a small revenue loss. Hence, the package of reforms does not increase the tax impost on investment and savings generally. It follows that the package should not have an adverse effect on the overall level of saving and investment in the economy.

A major beneficial effect of the reforms would be to improve the quality of investment. As discussed previously, the exemptions encourage tax-motivated investment in areas which are not necessarily, and indeed seldom are, of most benefit to the nation as a whole. A more neutral tax system would reduce the extent to which tax considerations intrude on investment decisions. The result would be a pattern of investment which is much more beneficial to New Zealand as a whole.

It is sometimes argued that tax concessions are necessary to encourage investment and that, conversely, the removal of concessions would be a disincentive to invest. For the reasons outlined above, it is easy to see that this argument is not correct. The overall level of investment in the economy cannot be significantly affected by the presence or removal of tax concessions for particular assets or activities. To the extent that one person enjoys a concession, someone else must pay more tax. If the first person is thereby encouraged to invest, the second person is discouraged. The principal effect of concessions is to change the **pattern**, not the **level**, of investment. Once investment patterns have adjusted and the tax benefit of the concessions has been fully impounded into asset prices, the concessions have little further impact, apart from maintaining an inappropriate pattern of investment.

A variant of the above argument is that the taxation of "capital gains", in particular, is detrimental to savings and investment. Once again, it is easy to see that this argument is incorrect.

Many forms of "capital gain" are already taxed as income. There is no reason to expect that reforms outlined in this document would have an adverse effect on savings and investment. Capital gains are income. An income tax system taxes income. It does reduce the incentive to save and invest but this is a general characteristic of an income tax system.

### **Effect on Risk Taking**

An income tax system taxes a proportion of income when a venture is successful and produces income. The more income that is produced, the more tax that is payable. Conversely, if a project fails, a loss will result. For the tax

system to be neutral with respect to projects of different risk, such losses should be deductible for tax purposes. Further, where the taxpayer has insufficient taxable income to fully utilise the loss, the excess loss should result in an immediate cash refund.

In practice, New Zealand's present income tax system, like those in other countries, does not provide for cash refunds of losses. Instead, taxpayers must carry forward losses for offset against future income. In the case of companies, the carry forward of losses is subject to a 40% shareholding continuity test. In view of these features, the present tax system is not neutral with respect to investment in activities with different levels of risk. Instead, to the extent that this consideration affects behaviour, there is a bias against risky activities.

Against this background, the removal of the present exemptions for income on capital account should not significantly change the impact of the present tax system on risk taking. Indeed, since income would not be recognised until assets are disposed of, there would continue to be a bias towards risky projects. The ring-fencing of certain income and losses will, however, further bias the tax system against investment in risky assets.

A separate argument sometimes advanced is that the present exemptions are necessary to encourage risk taking and that, if they were removed, risk taking would be discouraged. The main point here is that risk on its own is not a benefit. It is a cost both to investors and the community as a whole. If a project fails, the sunk costs are a loss to both investors and New Zealand. Risky projects are only valuable if they are expected to have a reasonable chance of a high return. It follows that there is no reason why the tax system should subsidise risky projects.

### **Revenue Impact**

There is no New Zealand data on income which is currently exempt from tax. Preliminary estimates of the revenue that would be obtained by removing the present capital income exemptions, based on extrapolating overseas data, suggest that it would be of the order of \$200-\$210 million per annum.

## **18.5 Concluding Comments**

The present Government has implemented a wide range of reforms of the tax system since 1984. The general objective has been to remove tax concessions, close loopholes, improve tax administration, widen the tax base and reduce income tax rates. The result of these reforms is that New Zealand now has a far more robust, efficient and equitable tax system than it had in 1984.

A number of major reform exercises have been undertaken. In each case, the approach has been to address the fundamental problems and adopt comprehensive solutions.

This is the approach that has been adopted in this Document. The Government initially announced that priority would be given to the analysis of the taxation of "capital gains". However, the problems with the present treatment of income from capital raise a wider set of issues. Consequently, this Document has a broad scope. It examines the treatment of income derived on the disposal of property as part of a thorough review of the way in which the present income tax system taxes income from capital.

At the beginning of the present reform programme in 1984, it was recognised that the interaction of the tax system with inflation produced adverse effects on both the efficiency and the equity of the tax system. The urgent need to address higher priority concerns, particularly statutory tax concessions and the major leakages in the tax system, meant that priority could not be given to the issue of inflation indexation. Now that the most pressing reforms have been implemented, it is possible to return to this issue.

It is appropriate to do this in conjunction with a review of the remaining exemptions, which arise largely from the historical development of case law rather than the Income Tax Act, for two reasons. First, both the exemptions and inflation undermine the neutrality of the income tax system. Both have an important impact. Hence, it is not sufficient to address one issue and not the other. Secondly, as the tax base is made more robust, pressures come on neglected elements. While the effect of inflation might have been tolerable when the tax system was full of holes, it is much less so when the rules are tightened and effective tax rates rise.

Accordingly, this Document has analysed the impact of removing the exemptions and the costs and benefits of comprehensive indexation in the context of a much broader analysis of the taxation of income from capital.





# APPENDIX 1:

## EFFECT OF REFORMS ON SAVING AND INVESTMENT

### 1 Introduction

Some observers have expressed concerns that expanding the tax base by eliminating exemptions for certain forms of capital income could adversely affect private saving. By so doing, elimination of exemptions could reduce capital formation and economic growth.

This appendix reviews economic research that bears on the question of whether the proposals in this document would reduce saving and investment. It outlines the behavioural responses that would have to occur for the proposals to affect saving adversely and reviews the conclusions of economic research with respect to each of those responses.

The appendix is organised as follows. Section 2 discusses the determinants of the private saving rate and reviews recent trends in private and overall national saving in New Zealand and other OECD countries. Section 3 examines the basic mechanism through which the reforms could affect private saving - a change in the after-tax return. It considers whether the reforms affect the after-tax return and, if so, whether a change in the after-tax return affects saving. Section 4 examines the broader effects of a shift in the domestic saving rate on domestic investment, international capital flows and economic growth. Section 5 presents concluding remarks.

### 2 Determinants of Private Saving and Recent Trends

#### 2.1 Introduction

In general, the timing of a person's income does not match exactly their desired timing of consumption outlays. As a result, people can be expected both to save and to borrow in order to match up desired patterns of outlays and receipts. For example, most wage earners receive their pay either at bi-weekly or monthly intervals, but must spend money on transportation, food, and other items either daily or more frequently. Thus, over short periods of time, income must necessarily either exceed or fall short of consumption.

The problem of matching income and expenditures occurs over longer time periods as well. Earnings of individuals vary from year to year and differ systematically among people of different ages. The amount of consumption outlays individuals must incur to maintain a constant living standard also varies among time periods depending on their family status, health and other

factors. In some cases, individuals can anticipate these changes in consumption requirements and in other cases they may not. Generally, however, these factors suggest that people would not normally try to equalise income and consumption in any single year.

People, of course, do not only consume income at different rates than they earn it. There is also a systematic tendency for private individuals, and societies as a whole, to consume less than they earn in any time period. In other words, net saving in most time periods is positive. Net saving is essential for growth in living standards and, together with capital imports from abroad, provides the resources for increased investment. Tax policy can affect the proportion of income that people save by altering the after-tax return to saving, by changing the form in which people save and by changing the distribution of income among people with different saving rates.

This section reviews research by economists that addresses the question of why people save. It reviews theoretical explanations of saving and empirical evidence that economists have produced in support of these theories. The section then briefly reviews recent trends in saving rates in New Zealand and overseas and discuss explanations for the apparent decline in private saving rates in advanced industrial nations during the 1980s.

## 2.2 Motivations for Saving

Economists have identified a number of reasons why people save.<sup>59</sup> We will classify these into 5 general categories:

- precautionary motives;
- saving for large purchases;
- saving to improve future living standards;
- life cycle considerations; and
- bequest motives.

All of the reasons for saving result from a desire of individuals to allocate current resources to future consumption either of themselves or for others. Nonetheless, the different motivations may suggest different amounts of

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<sup>59</sup> Keynes listed eight reasons: 1) to build a reserve against unforeseen contingencies (precaution), 2) to provide for an anticipated future relation between income and needs of the individual and (his or her) family different from that which exists in the present (life cycle), 3) to enjoy interest and appreciation (future living standards), 4) to enjoy a gradually increasing expenditure (future living standards), 5) to enjoy a sense of independence and the power to do things, 6) to secure a *masse de manoeuvre* for speculative or business projects, 7) to bequeath a fortune (bequest), and 8) to satisfy pure miserliness. J.M. Keynes, General Theory of Employment, Interest and Money, pp. 107-108.

substitutability between current and future consumption.

The precautionary motive is that people save to protect themselves against unanticipated future consumption needs, such as large required medical outlays, or to maintain current consumption in the event of an unanticipated loss of income. The need to save for large purchases, such as a home or a car, is a result of imperfect capital markets. If people could fully debt finance durable purchases, there would be no need for them to save for such purchases. Most lenders, however, require both some downpayment and some fixed period of repayment of a loan.

The desire to improve future living standards is a more general motivation. By saving, individuals can secure a steady growth in annual consumption even if they have a constant annual income stream. On the other hand, if earnings are growing, any single individual may not need to save in order to achieve a rising standard of living.

More generally, people can always gain some additional increase in future consumption if they refrain from consuming today. To the extent that real after-tax interest rates are positive, a dollar of forgone current consumption can allow people to gain more than a dollar of future consumption. If current and future consumption are highly substitutable, an increase in real after-tax interest rates, all other things being equal, will induce people to save more (or borrow less).

Recent economic literature on savings focusses on the last two motivations for saving - the life cycle motivation and the bequest motivation. In the life cycle model, the principal determinant of saving is the desire of people to smooth out consumption patterns over their entire lifetime in the face of an uneven pattern of earnings. Typically, earnings are low for young people, rise with age, and then level off, decline, and cease entirely after retirement. Consequently, the life cycle model implies modest dissaving rates for younger workers, high saving rates for workers during their peak earning years and dissaving during retirement. In a pure life cycle model, people will consume all their wealth before death and leave no bequest.

The life cycle model is based on work by Franco Modigliani and co-authors in the 1950s.<sup>60</sup> Subsequent writers have used the life-cycle theory of savings as the basis for simulation models designed to investigate the effects of changes in fiscal policy on saving, economic welfare and intergenerational wealth

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<sup>60</sup> Franco Modigliani and Richard Brumberg, "Utility Analysis and the Consumption Function: An Interpretation of Cross-Section Data," in K.K. Kurihara, ed. Post-Keynesian Economics, New Brunswick, Rutgers University Press, 1954 and Franco Modigliani and Albert Ando, "Tests of the Life Cycle Hypothesis of Savings: Comments and Suggestions," Bulletin of the Oxford University Institute of Statistics, 1957.

transfers.<sup>61</sup> These models assume that individuals consume all their wealth during their lifetime, but find that taxation and government debt policies affect the allocation of consumption among years within their lifetime and, by so doing, affect the overall rate of capital accumulation.

People may also save for the purpose of leaving a bequest to their children or to others, such as charitable institutions. Economists disagree on the extent to which wealth accumulation results from bequests instead of life cycle savings and on the extent to which bequests are intentional or accidental. There is no direct evidence that bears on the question of whether the size of any intended bequest depends on the after-tax return on savings.

## **2.3 The Life Cycle Model**

### **2.3.1 General Characteristics of Life Cycle Model**

The life cycle model implies that individuals will accumulate wealth during their working years and then decumulate during retirement. The resulting pattern of wealth accumulation is often called "hump savings" because total wealth of individuals rises to a peak at around age 55 or 60 and then declines to zero at death.

In the "pure" life-cycle model, individuals leave no bequests. Even so, total aggregate private saving will be positive if the population is growing and society's wealth will increase over time. This is because the saving of the more numerous younger generation will be greater than the dissaving of retirees. Because the life cycle model predicts large differences in saving rates among age cohorts, it also predicts that changes in the age distribution of the population will affect the aggregate saving rate over time.

### **2.3.2 Implications for Saving and Capital Accumulation: Simulation Results**

As noted above, economists have used the life cycle model to simulate the effects of taxes and other government policies on private saving. The life cycle model yields some powerful insights, but conclusions of researchers also depend on a number of other specific assumptions about people's behaviour.

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<sup>61</sup> See, for example, Lawrence H. Summers, "Capital Taxation and Capital Accumulation in a Life Cycle Growth Model," American Economic Review, September 1981 and Alan J. Auerbach and Laurence J. Kotlikoff, Dynamic Fiscal Policy, Cambridge, Cambridge University Press, 1987.

Typically, life cycle models of consumer behaviour express individuals' preferences mathematically by means of a utility function. The utility, or well-being, of an individual, is assumed to depend on the amount of consumption in each year of his or her life. In the pure life cycle models, individuals receive no utility from terminal wealth and will attempt to spend all of their income during their lifetime.

The mathematical form of the utility function is complex. Researchers generally use a flexible form that enables them to specify a parameter value for the "intertemporal elasticity of consumption." The intertemporal elasticity of consumption indicates the amount by which individuals will substitute next year's for this year's consumption in response to a change in the relative price of next year's consumption. The price of next year's consumption is simply the amount of today's consumption that individuals must sacrifice to obtain an additional dollar's worth of consumption goods next year. It is equal to  $1/(1+i)$ , where  $i$  is the real after-tax interest rate. Thus, if  $i$  is 5 percent, the price of a dollar of next year's consumption is approximately 95.2 cents.

An increase in the real interest rate is associated with a decrease in the price of next year's consumption. For simplicity of exposition, economists often portray the effects of a change in the real interest rate using a two-period life cycle model. The two periods represent working years and retirement. The model assumes that all earnings are in the first period and that total consumption in the two periods is equal to total lifetime resources. In this simple conceptual model, current consumption may either increase or decrease in response to an increase in the real interest rate. The net effect on consumption depends on the relative size of "substitution" effects and "income" effects.

The substitution effect occurs because the relative price of future consumption in terms of current consumption is lower when the interest rate increases. People respond by substituting future consumption for current consumption. This increases current saving. The income effect measures the increase in people's total well-being from the price change. The income effect is positive because, with a higher interest rate, individuals in the 2-period model can increase both present and future consumption without exceeding their lifetime budget constraint. Thus, the income effect is associated with a reduction in current saving. The net effect of an interest rate change on current saving in this simple model is ambiguous.<sup>62</sup>

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<sup>62</sup> If the intertemporal elasticity of substitution is greater than one (in absolute value), an increase in the after-tax interest rate will increase current saving; if the elasticity of substitution is less than one, saving will fall. In the special case of a Cobb-Douglas utility function, in which the elasticity of substitution is unity, saving will be unaffected by the change in the after-tax interest rate.

Summers has shown that the analysis using the two period life-cycle model outlined above can change dramatically if one expands the model to include multiple time periods.<sup>63</sup> Summers simulates a multi-year life cycle model, with the pattern of earnings over an individual's lifetime roughly consistent with reported age-earnings profiles in the United States. His simulations show that increases in the after-tax interest rate have a strong affect on the private saving rate and capital accumulation. Summers estimates that the elasticity of the saving rate with respect to the after-tax interest rate could be as high as 2.0. (This means that a one percent change in the after-tax return increases the saving rate by 2 percent.)

The main factor causing the multi-period results that Summers derives to differ from the results using the 2-period model is the wealth effect of higher interest rates. In the multiperiod model, people dissave in their early working years because they anticipate higher future earnings. An increase in the interest rate has a negative wealth effect in the multi-period model because it reduces the present value of future earnings. (This effect does not appear in the simple 2-period model because there are no earnings in the second period.) As a result, young workers dissave less with higher interest rates and the entire time profile of consumption shifts backwards to later years. This deferral of consumption significantly increases the aggregate saving rate and capital accumulation.

Evans has criticised Summers' conclusions on several grounds.<sup>64</sup> He contends that Summers' findings are highly sensitive to the parameterisation of his model. With lower assumed values of the intertemporal elasticity of substitution, the interest elasticity of saving derived from a life cycle model could fall to close to zero. Moreover, if one departs from the life cycle model and takes bequests into account, Evans finds that the saving rate could respond negatively to an increase in the after-tax interest rate.<sup>65</sup> He concludes that simulation models cannot answer the question of how much, or in what direction, saving changes in response to changes in the after-tax interest rate. In response, Summers argues that even with low substitution elasticities, Evans' results imply that the after-tax interest rate increases savings in pure

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<sup>63</sup> See Lawrence H. Summers, *op. cit.* 1981.

<sup>64</sup> See Owen J. Evans, "Tax Policy, the Interest Elasticity of Saving, and Capital Accumulation: Numerical Analysis of Theoretical Models," American Economic Review, June 1983.

<sup>65</sup> Evans assumes that desired bequests are insensitive to the after-tax interest rate. If bequests also depend on the "price" of bequests, in terms of foregone lifetime consumption, then the response of saving to interest rates will be larger (more positive) than in Evans' simulations. There is, however, no direct empirical evidence on the price substitutability between lifetime consumption and bequests.

life-cycle models. Summers further argues that if people leave altruistic bequests, the response of saving to after-tax interest rates will be larger, not smaller, than the response found in life cycle models.<sup>66</sup>

Auerbach and Kotlikoff have performed a much more extensive set of simulations of the effects of fiscal policies on capital accumulation using a life cycle model.<sup>67</sup> In the Auerbach and Kotlikoff model, there are 55 sample consumers, representing overlapping generations. Each generation begins work (and private consumption) at the age of 21, works until age 65 and dies at age 75. The model is a pure life-cycle model; people leave no bequests. Households have an intertemporal utility function that depends on consumption of goods and leisure in different time periods. They are assumed to have perfect foresight and make decisions consistent with a correct anticipation of all future prices. They maximise utility given the relative prices of current and future consumption (the after-tax interest rate), the relative price of leisure (the after-tax wage rate), and their initial endowment of labour. A production function relates total output to inputs of capital and labour. Government imposes income and/or consumption taxes, issues debt, purchases goods and services and operates a retirement program. The government faces a budget constraint that requires that the present value of tax collections (net of transfers) must equal the present value of goods and services it purchases plus the initial value of government debt.

The model assumes a closed economy so that private investment equals total private saving less the government deficit. Investment is undertaken to close the gap between a firm's desired capital stock and the capital stock in the preceding period. An important feature of the model is the assumption of adjustment costs that increase with the level of investment. This reduces the extent to which investment subsidies can cause the market value of used capital to diverge from its replacement cost. Still, changes in fiscal policies can affect current market values as well as future rates of return. That is, policy changes can have "lump sum" as well as relative price effects.

Auerbach and Kotlikoff use their model to simulate the effects on saving, capital accumulation, total output, and the intergenerational distribution of income of changes in tax and debt policies. They note that, as with all such simulation models, results are sensitive to the assumptions used in parameterising the model. Nevertheless, the use of a life cycle model with positive adjustment costs of changing investment levels yields some important insights about the differential effects of fiscal policies.

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<sup>66</sup> See Lawrence H. Summers, "The After-Tax Rate of Return Affects Private Savings," American Economic Review. May 1984.

<sup>67</sup> See Auerbach and Kotlikoff, op. cit. 1987.

The most important insights for the present purpose concern the differential effects of savings and investment incentives and the differences between short-run and long-run outcomes. Auerbach and Kotlikoff define savings incentives as those that apply to all capital, while investment incentives only apply to newly installed capital. Their simulations show that investment incentives increase capital formation and economic welfare, while savings incentives reduce economic welfare.

The difference in the effects of investment incentives and savings incentives result from differences in their effects on the intergenerational distribution of the tax burden. Both savings and investment incentives can increase the after-tax interest rate and, other things equal, cause people to substitute future consumption for present consumption. But their wealth effects differ dramatically. Investment incentives reduce the value of old capital and transfer resources from older to younger taxpayers.<sup>68</sup> The revenue from this "lump sum" tax on the older generations can finance lower marginal tax rates, thereby improving work and savings incentives. In contrast, savings incentives provide a windfall to older generations, who now pay a lower tax rate on income from wealth that they have either inherited or accumulated when they were younger. Marginal tax rates on everyone, including the current generation of workers, must be increased to finance this lump sum tax cut.

The reforms in this Document for removing exemptions for certain forms of capital income are reductions in savings incentives in the sense that the term is used in the Auerbach-Kotlikoff framework. Their model would imply that eliminating exemptions for capital income may increase economic welfare if the revenue were used to lower marginal income tax rates, even though this change could result in a slightly smaller capital stock. The gain in economic welfare is a consequence of the lump-sum tax on old capital, not of the long-run superiority of a tax system with higher rates of tax on income from capital.

## 2.4 Bequests

People have a variety of reasons for leaving bequests to their children and others. The main issue, however, is whether bequests are primarily accidental or are based on the deliberate intention to pass on wealth to one's children.

The life cycle model predicts that people will decumulate wealth during retirement because they seek to consume all of their wealth during their

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<sup>68</sup> Investment incentives reduce the value of old capital because old capital and new capital are substitutes. By lowering the price of newly purchased capital (because government pays for part of the cost), it forces down the price of used assets. To the extent that there are adjustment costs in increasing investment, the decline in the price of old capital will be less than the amount of subsidy to new capital.



lifetime. If people die before this decumulation process is complete, they will leave an unintended bequest. Moreover, people may save to protect themselves against living longer than expected and consequently running out of wealth.

People can insure against the possibility of long life by purchasing annuities. But generally private annuities (as distinct from employer and government pensions) are available only on unfavourable terms. Moreover, there are some risks, such as extraordinary medical expenses or the need for long-term nursing home care, against which some people cannot fully insure themselves. Thus, there may be still be a substantial amount of bequests even if people are basically "life-cycle" savers interested only (or primarily) in their own consumption.

Alternatively, people may be altruistic and may attempt to maximise intergenerational utility, including the welfare of their children. In an extreme version of the intergenerational model, people are ultra-rational and perceive all the effects of corporate and government saving on their wealth and the potential consumption of their descendants.<sup>69</sup>

The existence of bequests as well as life-cycle savings alters theoretical findings about the effects of after-tax interest rates on saving and capital accumulation. But the direction of change in the response of saving to the rate of interest depends on the motivation for bequests. In the extreme version of the model characterised by altruistic bequests, ultra-rationality and intergenerationally-linked markets, saving is infinitely interest-elastic. People will substitute future consumption for present consumption without limit as long as the marginal productivity of capital (the return on investment) is greater than the "natural" long-run growth rate resulting from population growth and labour-augmenting technical change. On the other hand, if bequests are accidental, or people have a fixed target bequest, either in absolute terms or as a proportion of income, then the interest-elasticity of saving will be lower than in a pure life-cycle model with the same intertemporal substitutability between consumption in different years.

## 2.5 Evidence on Relative Importance of Life Cycle and Bequest-Motivated Saving

The relevance of the policy implications of simulations using the life cycle model depend in part on whether life cycle savings account for a significant fraction of total wealth accumulation. If intergenerational transfers instead of life cycle savings are the main source of wealth accumulation, the results from simulations of life cycle models are less relevant. The simulations may still

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<sup>69</sup> For an exposition of the ultra-rational view, see Robert J. Barro, "Are Government Bonds Net Wealth," *Journal of Political Economy*, December 1974. In the Barro model, government debt policies have no effect on private saving; private sector agents will increase saving to offset any increase in the government deficit.

matter, however, under certain assumptions about the motives for intergenerational transfers.

Unfortunately, there is no consensus amongst economists on these issues. Economists differ on the extent to which life cycle savings and intergenerational transfers, respectively, are regarded as the main source of total wealth accumulation. Moreover, as noted above, the motives for intergenerational transfers, and thus the factors that may influence their desired size, are unclear.

Modigliani contends that life cycle motives explain most of wealth accumulation.<sup>70</sup> He cites studies that find that bequeathed wealth (excluding interspousal transfers) accounts for between 15.5 percent and 18.5 percent of total wealth in the United States. Some research in the United Kingdom yields similar estimates. Based on this and other studies, Modigliani concludes that a pure bequest motive, which he defines as the accumulation of wealth entirely for the purpose of being distributed to heirs, affects a rather small number of households who are mostly in the highest income and wealth brackets.

Research by Kotlikoff and Summers produces dramatically different estimates. Kotlikoff and Summers use two different approaches which find that intergenerational transfers account for between 46% and 81% of total wealth.<sup>71</sup> Kotlikoff, in a subsequent paper, suggests a lower bound estimate of 63 percent.<sup>72</sup>

Differences in conceptual definitions account for a large share of the difference between the Kotlikoff-Summers (K-S) findings and previous work. First, K-S treat consumption of people over 18 who are still dependents as dissaving, thus increasing the component of their ultimate saving attributable to inheritance. In particular, they treat educational expenditures as part of inherited wealth. Second, in contrast to previous studies, K-S include the capitalised value of returns on inheritances as part of the share of wealth accumulation they attribute to transfers. Other writers counted all lifetime saving, from both past earnings and inherited wealth, as life cycle savings.

Kotlikoff concludes that the evidence supports a position that intergenerational transfers play a very important and perhaps dominant role in wealth accumulation in the United States. But he also concludes that motives for these transfers remain unclear. Intergenerational transfers may be a result of imperfect annuities markets. If individuals cannot purchase private annuities

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<sup>70</sup> See Franco Modigliani, "The Role of Intergenerational Transfers and Life Cycle Saving in the Accumulation of Wealth," *Journal of Economic Perspectives*. Spring 1988.

<sup>71</sup> Laurence J. Kotlikoff and Lawrence H. Summers, "The Role of Intergenerational Transfers in Aggregate Capital Accumulation," *Journal of Political Economy*. August 1981.

<sup>72</sup> Laurence J. Kotlikoff, "International Transfers and Saving," *Journal of Economic Perspectives*. June 1988.

on actuarially fair terms, they must save against the risk of living longer than expected and would consequently leave unintended bequests. If most bequests are unintentional, behavioural implications may be very similar to those in the pure life cycle model.

Kotlikoff cites some evidence, however, that many people decline to purchase actuarially fair annuities even when they are available. This casts doubt on the "accidental bequest" theory. Evidence for competing theories of transfers is also scanty. For example, several studies raise doubt about the "altruistic model" in which people intentionally save to leave bequests for their children. For example, one study found no significant difference in decumulation between elderly households with children and those without them. Other research found evidence that wealth bequeathed to children is shared equally, in contrast to an "altruistic" model in which parents are inclined to leave more money to their less well-off children.

This review of the basic reasons why people save leaves many questions unanswered. No single, simple theory appears to explain all the diverse reasons people save or the factors that may cause the aggregate rate of saving to change. The most that one can conclude is that different people save for different reasons and that all the theories explain the behaviour of some members of the population. The "intentional" bequest theories are relatively better at explaining the behaviour of the most affluent groups, while the "life cycle" and accidental bequest approaches may better explain the behaviour of the rest of the population.

Further, most of the studies of the relative strengths of the life cycle and bequest motives have been performed using data from the United States although, as noted above, some parallel work has been done in the United Kingdom. One might expect motivations for saving to be similar in all Western democracies, but the weights of different factors may differ somewhat for New Zealand.

## **2.6 Recent New Zealand and International Experience**

### **2.6.1 New Zealand**

The household saving rate in New Zealand has declined in the 1980s. Net household saving as a percentage of household disposable income averaged about 7.9% between 1974 and 1979 and 7.1% between 1980 and 1987. In recent years, the household saving rate has been much lower - 3.5% in 1986 and 2.8% in 1987 - but this decline has been offset by an increase in other sources of saving.

Even though the household saving rate has declined, net national saving as a percentage of gross domestic product has remained roughly stable. The ratio of net saving to GDP in New Zealand increased slightly from 12.3% in 1974-79 to

12.7% in 1980-87. The national saving rate in recent years has been close to the decade's average - 13% in 1986 and 12.3% in 1987. This means that changes in corporate and government saving rates have offset changes in household saving rates. In particular, the reduction in the government deficit in the latter part of the 1980s offset the decline in household saving, thereby preventing a fall in the national saving rate.

## 2.6.2 Other OECD Countries

There are significant problems in defining and measuring saving rates. This means that any published figures should be interpreted with caution. Measurement problems are particularly severe in making cross-country comparisons because different countries may use somewhat different conceptual methods in their national accounts. Data on trends in saving rates over time within countries are more reliable, but again estimates are imprecise and economists differ about what should be included in measures of saving.

Most OECD countries, including New Zealand's major trading partners, have experienced a decline in both household saving rates and national saving rates in recent years. Between 1974-79 and 1980-87, household saving as a percentage of net disposable income fell from 13.3% to 10.8% in the G7 nations, from 11.8% to 10.0% in the smaller OECD countries, and from 13.1% to 10.7% for the entire OECD. In New Zealand's three largest trading partners, the private saving rate also declined - from 12.7% to 9.3% in Australia (the latter figure in Australia is for 1980-86), from 21.6% to 16.6% in Japan, and from 9.6% to 7.7% in the United States. In 1987, household saving rates declined further - to 5.5% in the United States and 15.1% in Japan.

The ratio of net national saving to GDP also declined in most of the OECD. Between 1974-79 and 1980-87, the national saving rate declined from 11.9% to 7.9% in the G7 nations, from 12.8% to 9.6% in the remainder of the OECD, from 7.7% to 3.7% in the United States, from 8.6% to 3.4% in Australia and from 20.2% to 17.6 percent in Japan.

The figures indicate that household and national saving rates have been declining throughout the developed world in the past decade. In contrast, the national saving rate in New Zealand has remained roughly constant. New Zealand experienced a larger decline in the household saving rate in 1986 and 1987 than other countries, but has maintained its total saving rate, while total saving rates have declined elsewhere.

## 2.6.3 Possible Explanations of Declining Private Saving Rates

There are a number of possible reasons for the decline in private saving rates in the 1980s. These include:

- changes in the age distribution of the population;
- improved capital markets;
- target saving goals of superannuation funds; and
- lower saving propensities of the current generation.

The decline in saving rates does not appear to be a response to lower after-tax interest rates. In fact, real after-tax interest rates increased in many countries during the 1980s. Real pretax interest rates increased and marginal tax rates declined.

### **Age distribution**

Many OECD countries (with Japan a notable exception) experienced low birth rates in the 1930s and exceptionally high birth rates in the decade following World War II. The small depression-era cohort was in the 45-60 age range during the 1980s, the age range in which saving rates are highest for life cycle reasons, while the large "baby boom" generation was still in the early work and family formation years. According to this explanation, saving rates should increase in the 1990s as the postwar generation begins to save more. One recent study has found, however, that the change in the age composition of the population explains very little of the decline in the private saving rate in the United States.<sup>73</sup>

### **Improved capital markets**

A number of countries, including New Zealand, have reduced controls on financial markets in recent years. New Zealand removed foreign exchange controls and de-regulated financial markets after 1984. Financial deregulation increases potential returns on savings for individuals, but also has increased access to and availability of borrowed funds. For example, prior to deregulation, tight monetary policies took the form of credit rationing through higher required deposits for loans, more extended repayment periods and stricter standards for loan approvals. Since deregulation, most people can borrow more readily. The proliferation of financial instruments, such as variable-rate mortgages, has also enabled lenders to shift some financial risk to borrowers and thus has probably increased their willingness to lend. This has reduced the saving individuals must do to acquire houses and other consumer durables.

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<sup>73</sup> Lawrence H. Summers and Chris Carroll, "Why is the U.S. National Savings Rate So Low?" Brookings Papers on Economic Activity, 1987. For a similar result for Australia, see Economic Planning Advisory Council, Trends in Private Saving, Council Paper No. 36, December 1988.

## "Target" savings goals of retirement funds

Many company retirement plans are "defined benefit" plans that guarantee to employees a fixed retirement income based on their years of service and either final or average wages when employed. The increase in nominal interest rates in the 1980s, compared to the two previous decades, reduced the contribution required of employers to fund promised retirement benefits. This had the immediate effect of reducing private saving.

The short-term reaction of retirement fund managers is an illustration of the "income" effect of higher interest rates outweighing the "substitution" effect. With higher returns per dollar of saving, the same future consumption can be achieved with higher current consumption and less current saving. This may be a short-run effect, however, dictated by particular fiduciary rules. If high interest rates persist, and people therefore perceive that the price of future consumption in terms of current consumption is lower, they may either bargain for more generous retirement benefits in place of current wages or take advantage of the higher rate of return by saving more outside of retirement plans.

## Lower propensity to save of current generation

A final explanation is that people today simply have a lower propensity to save than did earlier generations. For example, a recent paper by Boskin and Lau identified a significant "generation effect." They found that households headed by persons born since 1939 consume a larger share of their wealth than those born prior to 1939, after controlling for age and other variables affecting consumption.<sup>74</sup> This "generation" effect appears to explain the bulk of the decline in the private saving rate in the United States.

The identification of a lower propensity to save of the postwar generation does not in itself indicate why the propensity to save has declined. There are several possible explanations. First, the postwar generation has no experience of the great depression or of other major economic upheavals characterised by mass unemployment and declining prices. Thus, they do not have the fear of debt of earlier generations. In fact, the postwar inflation has generally benefited debtors. Second, compared to earlier generations, the postwar generation has found it easier to borrow throughout their lifetime and thus may be unaccustomed to think of the need to save for large outlays. Finally, since the 1930s, New Zealand and most other OECD nations have had extensive systems of public support for retirees, including superannuation benefits and financial

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<sup>74</sup> See Michael J. Boskin, "Consumption, Saving and Fiscal Policy," *American Economic Review*, May 1988 and Michael J. Boskin and Lawrence J. Lau, "An Analysis of Postwar U.S. Consumption and Savings Behavior," mimeo, Stanford University, 1988.

support for medical costs. The improved well-being of old people that results from these programmes may lead the current generation to perceive that there is less need to save for old age.<sup>75</sup> While all these are possible explanations, they are still speculations and not confirmed research findings.

## 2.8 Conclusions

People save for a variety of reasons. Economists stress two main motivations for long-term savings -

- saving for retirement consumption (life cycle savings); and
- saving for bequests.

The relative extent to which the two types of saving contribute to the accumulation of capital is in dispute. Moreover, there is also uncertainty as to whether bequests are primarily intentional or are an unintended consequence of imperfect annuity markets and precautionary saving. Understanding the motivation for saving matters because different models of saving behaviour imply different responses of savers to changes in government policies.

## 3 Effect of Proposals on Private Saving

### 3.1 Introduction

The previous section discussed theories of saving, general determinants of household saving rates and recent trends in saving behaviour. The reforms of the taxation of income from capital discussed in this Document may affect the overall rate of saving. They could do this by affecting one potential influence on saving - the after-tax rate of return on capital. While other factors may be more important determinants of the saving rate, changes in the after-tax rate of return can cause saving to be larger or smaller than it otherwise would be.

There is no consensus among economists, however, on whether changes in after-tax yields by themselves have a significant effect on the rate of saving. Some economists believe that an increase in the after-tax return will have a positive and significant effect on the saving rate. Others believe the interest responsiveness of saving is zero or negligible and may even be negative.

The next part of this section discusses briefly how the proposed reforms might affect the after-tax return. The section then turns to the question of how a change in the after-tax return could affect the rate of private saving.

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<sup>75</sup> Feldstein found that the unfunded social security retirement programme in the United States reduced private saving, but others have challenged this finding. See Martin Feldstein, "Social Security, Induced Retirement, and Saving," *Journal of Political Economy*, September-October 1974.

## 3.2 Effect of Reforms on After-tax Returns

This document presents two groups of reform of the income tax base -

- reforms that broaden the income tax base to include some forms of income from capital that are currently exempt; and
- reforms that eliminate the overstatement of income from capital by allowing taxpayers to adjust the cost of assets for inflation in computing net income from the sale of assets, net income from trading stock, and depreciation allowances.

The net effect of all of these reforms on the total tax burden on capital income is uncertain. If the rate of inflation is zero or very close to zero in future years, the effect of the reforms will be to increase the total taxation of income from capital. If the inflation rate remains at current levels or increases, the reforms will reduce the total taxation of income from capital.

Even if the reforms increase the total tax burden on capital income, they will still improve the productivity of capital because they eliminate selective exemptions. Under the proposed reforms, capital will not be diverted to the same extent to investments with low (risk-adjusted) pre-tax returns in order to gain tax concessions. The tax system will become more neutral among different uses of saving.

The base-broadening reforms by themselves (apart from the effects of indexation) will increase the total tax burden on all saving. By initially changing relative after-tax returns among assets, they will initially lower the market value of previously tax-favoured assets and increase the value of fully-taxed assets. Thus, the initial impact reduces income only for holders of previously exempt assets. Savers will then reallocate their portfolio holdings, shifting funds out of assets that had been tax-favoured until risk-adjusted after-tax returns among assets are again equalised, but at a lower after-tax yield than before the reforms. This shift of funds will spread the initial burden of the tax among all savers, no matter what assets they own.

As noted above, the reforms may not result in any increase in the average tax rate on income from capital because the effects of base broadening will be offset by indexation of some forms of capital income. Still, partial enactment of some of the reforms could result in some modest increase in the overall tax rate on income from capital, and enactment of all the reforms could also increase the effective tax rate relative to current law if the rate of inflation declines. Conversely, if the rate of inflation increases, enactment of all the reforms will reduce the tax rate on income from capital, compared to what it would become under current law.



Even if the proposals do raise the overall tax rate on income from capital, however, they still may not adversely affect private saving. The following section discusses economic theory relating to the effects on saving and economic efficiency of raising the tax rate on income from capital. It then briefly review empirical evidence bearing on this question.

### **3.3 Effects of Capital Income Taxes on Saving: Theoretical Considerations**

An increase in capital income taxes could reduce saving by lowering the after-tax return received by savers. Economic theory does not establish that saving will decline with a decrease in the after-tax interest rate. Of more relevance, the literature also does not establish that changing the tax mix in a revenue neutral way by increasing the taxation of capital income and reducing the taxation of labour income or consumption will necessarily decrease saving or reduce economic efficiency, although under some assumptions that will be the case.

The theoretical literature assumes that consumers act in a rational and purposeful way to maximise their "utility." Utility depends on both present and future consumption. The choice between the two depends to some degree on their relative prices. A decrease in the after-tax interest rate increases the relative price of future consumption. This will, according to economic theory, cause consumers to decrease future consumption.

Under some sets of assumptions, a decrease in the after-tax interest rate brought about by increasing capital income taxation necessarily reduces saving. In particular, this is the result in a simple model of the economy with people choosing between consumption in two time periods and with labour supply fixed. In this model, lump sum taxes, labour income taxes and consumption taxes at a single rate all leave the relative price of present and future consumption unchanged and are thus "neutral" between present and future consumption. On the other hand, an income tax that includes income from capital in the base causes people to substitute present consumption for future consumption because it lowers the after-tax interest rate (i.e., raises the relative price of future consumption). Thus, a revenue-neutral switch in the tax base from wage taxes (or consumption taxes) to taxes on income from capital will necessarily reduce saving.

The conclusions from this simple model do not apply, however, when account is taken of other factors. The most important of these is labour supply.<sup>76</sup> If labour supply is not fixed, then consumers are choosing among three goods - leisure, current consumption, and future consumption. A decrease in the after-tax interest rate will still have a substitution effect against future consumption,

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<sup>76</sup> The discussion here follows the logic in a review paper of the theory of savings behaviour by Sandmo. See Agnar Sandmo, "The Effects of Taxation on Savings and Risk Taking,"

but households may achieve this either by increasing current consumption (i.e., saving less) or by increasing leisure (i.e., working less). If current and future consumption are complements, they may decrease current as well as future consumption which would allow them an even greater increase in leisure. In contrast, an increase in the after-tax wage rate through lower taxes on wage rates will have a substitution effect against leisure (increase work effort), which households may offset by increasing either present and future consumption.

In general, the possibility that labour supply is sensitive to relative prices, means that it is not possible to conclude that substitution of a tax on capital income for a wage tax will necessarily reduce current saving. What is involved is a comparison of two cross-price effects on current consumption and the reasoning based on economic theory does not dictate the outcome.

Economic theory also has little to say about the optimum tax mix between taxes on labour income and on capital income. If there are no cross-price responses and labour supply is fixed, the optimal tax rate on capital is zero and broad-based taxes on labour income can be made as high as possible. Alternatively, if the demand for future consumption is not price-sensitive, the conclusion is reversed and capital income is the ideal tax base (assuming taxes fall equally on all forms of capital income). In general, the optimal tax mix depends on the relative magnitudes on the substitutability between present and future consumption and between labour and leisure. Because the size of these responses are not known, it is not possible to determine which, mix between labour income taxes and capital income taxes maximises economic efficiency. Moreover, there is no reason to believe that maximum economic efficiency occurs when tax rates on labour income and capital income are equal.

### 3.4 Empirical Findings on Savings Response to Interest Rates

The empirical work on the relationship between savings and after-tax interest rates is also inconclusive. Some studies have found a statistically significant and large responsiveness of private saving to changes in after-tax returns. Other research has disputed these findings. Moreover, all of the statistical work on this topic has serious conceptual shortcomings.

The principal research result that economists cite in support of the proposition

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in Alan J. Auerbach and Martin S. Feldstein, eds., Handbook of Public Economics. Similar conclusions are reached in A. Lans Bovenberg, "Tax Policy and National Saving in the United States: A Survey," National Tax Journal, June 1989.

that interest rates influence saving positively is a study by Michael Boskin.<sup>77</sup> Boskin examined the historical relationship between private saving and after-tax interest rates in the United States and estimated that a one percent increase in the after-tax interest rate raises private saving by 0.4%. Boskin's estimate of the responsiveness of saving to interest rates was much higher than estimates reported in earlier studies.<sup>78</sup> Subsequent researchers challenged Boskin's findings and maintained that the evidence failed to demonstrate a positive relationship between savings and interest rates.<sup>79</sup>

The studies of the relationship between saving and interest rates are based on historical data on aggregate consumption, bond yields and marginal tax rates. They confront a number of conceptual difficulties of which three are worth noting. First, there is no direct measure of the effects of changes in tax policy. Instead tax effects are inferred from changes in after-tax interest rates. Second, researchers use nominal after-tax interest rates in their equations even though it is the real after-tax rate (the nominal rate minus expected inflation) that should influence saving. Expected inflation cannot be observed directly. Finally, it is not clear that annual rates are relevant for saving behaviour. If savers are primarily influenced by life cycle or bequest considerations, a measure of the expected long run rate of return would seem more likely to influence their behaviour than the current period's yield.

In conclusion, researchers have found some statistical evidence that changes in after-tax interest rates change private saving in the same direction. There is no consensus, however, on what the statistical evidence implies. Moreover, there are a number of conceptual shortcomings in using historical data to test the relationship between private saving and interest rates. This raises further doubts about existing studies. But it is also possible that there is a significant positive long-run relationship between saving and interest rates that studies based on quarterly or annual data are unable to detect.

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<sup>77</sup> Michael Boskin, "Taxation, Saving, and the Rate of Interest," Journal of Political Economy, 1978.

<sup>78</sup> For example, Wright found a response only 1/10 as large as Boskin. See. C. Wright, "Saving and the Rate of Interest," in A.C. Harberger and M.J. Bailey, eds., The Taxation of Income from Capital. Brookings Institution, Washington D.C., 1969.

<sup>79</sup> See, for example, E. Philip Howrey and Saul H. Hymans, "The Measurement and Determination of Loanable Funds Savings," and comments by Robert Z. Lawrence, Michael J. Boskin, and John A. Brittain in Joseph E. Pechman, ed., What Should be Taxed: Income or Expenditure. Washington D.C., Brookings, 1978.

## **4 Determinants of Broader Economic Effects of Changes in the Rate of Saving**

### **4.1 Introduction**

The previous sections have shown that there is no reason to assume that the reforms that this Document discusses will reduce the private saving rate in New Zealand. Nevertheless, under certain assumptions, the private saving rate may decline slightly. This section discusses some of the broader consequences of a decline in the private saving rate.

Private saving can finance domestic investment, government borrowing, or international loans and investments. If the reforms are assumed to be revenue neutral, a change in the saving rate will affect either domestic investment or net capital outflows. The next part of this section discusses evidence on the relative magnitudes of each. It then discusses the relationship between increased investment and economic growth.

### **4.2 Saving and International Capital Mobility**

The effect of changes in domestic saving on domestic investment and international lending depends on the characterisation of world capital markets. If the best characterisation is one capital market linking most world economies, an increase in domestic saving in New Zealand will simply spill over into the world capital markets. It will not perceptibly affect either domestic interest rates or domestic investment. On the other hand, if there is little relevance to the concept of a world capital market, an increase in the domestic saving rate will lower domestic pre-tax interest rates and increase domestic investment. There are conflicting views among economists concerning which of these perspectives is closer to reality.

Under the assumption that one world capital market best describes reality, the effect on domestic investment of removing a selective exemption for one form of saving may differ from the effect of an across the board tax increase on income from capital. The effect of removing an exemption for one form of saving depends on how the exemption affects relative returns to New Zealand savers in domestic and overseas assets and on how it affects returns to foreign investors in New Zealand assets. Removing the exemption from tax for income on capital account will eliminate a preference for both domestic and overseas assets held by New Zealanders and consequently will probably not significantly affect the pre-tax return they must earn to invest their savings in New Zealand. The cost of equity capital from overseas investors in certain New Zealand assets may rise, however. The effect on the cost of overseas funds depends on the extent to which foreign investors actually must pay the new tax rates on the previously favoured assets and the extent to which those New Zealand taxes are not offset by foreign tax credits on their home country tax returns.

Suppose, for example, that foreign countries allow their residents a tax concession for income on capital account and thus tax such income at a lower rate than income on capital account in New Zealand under the new proposals. Most countries limit the foreign tax credit rates to the domestic tax rate, based on their rules for calculating assessable income.<sup>80</sup> Thus, investors from some countries with low tax rates on income from capital will probably pay a higher tax rate on certain assets in New Zealand than the tax rate they would confront on similar assets at home or in other foreign countries.

How widespread this effect would be, and whether it would actually lead to an increase in the cost of capital in the long term to some New Zealand enterprises is difficult to determine. Some of New Zealand's major trading partners, notably Australia and the United States, will continue to tax real income on capital account at a higher rate than New Zealand would tax such income under the proposals in this document. For other countries, notably Japan, the tax rate on income from domestic investments will be lower. Thus, for some countries the reforms could cause a rise in the pre-tax return their investors require on some New Zealand assets. This could result in a modest decline in investment in selected assets. Alternatively, it could simply result in a reallocation of sources of funds from overseas for particular investments. Investors from countries with low tax rates on income from capital will continue to hold debt assets in New Zealand, while a greater proportion of equity assets will be held by New Zealanders and by residents of foreign countries with relatively high taxes on income from capital account.

The basic facts of international finance appear to support the one world capital market model. There are active international markets in debt instruments of most countries, currencies are freely convertible between New Zealand and its major trading partners and many investors appear to regard debt instruments of different countries as close substitutes and respond to intercountry differentials in real interest rates, adjusted for expected changes in currency values. There is also a substantial flow of real capital among countries, particularly within multinational companies.

In spite of this apparent integration of world capital markets, there is evidence that domestic saving matters in determining domestic investment. Feldstein and Horioka performed statistical tests correlating data on gross investment and gross saving rates in 21 OECD countries. They found a close statistical correlation between saving and investment. A one percentage point increase in

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<sup>80</sup> The foreign tax credit limitation may not be effective for investments in any one country, to the extent that taxpayers can combine income from high-tax countries with income from low-tax countries. Specific provisions for limiting how taxpayers can use foreign tax credits differ among countries.

the saving rate was associated with an increase in the investment rate of 0.9 percentage points. They interpreted their results to mean that most incremental saving remains in the country where the saving occurs.<sup>81</sup>

Feldstein and Horioka conclude that the evidence they present is incompatible with the hypothesis of a perfectly mobile world capital stock. They suggest that there are sufficient rigidities and locational preferences to keep most of any additional saving invested in the country of origin. This means that it is appropriate to analyse the effects of tax policy changes without considering international capital mobility.

Harberger disputes the Feldstein-Horioka perspective, although he also regards the world capital market as less than perfect.<sup>82</sup> Harberger finds a rough tendency for equalisation of after-tax returns among countries and no systematic tendency for rates of return to be higher in countries with little capital per worker. These data are consistent with the world market view. Harberger also contends that the high observed correlation between saving and investment rates for large countries can occur for a variety of reasons other than impediments to capital mobility. He notes that small countries have much greater variability between saving and investment rates than do large countries.

Harberger concludes that an intermediate position between the perfect world capital market and closed economy perspectives makes the most sense. In particular, capital-importing countries may raise more funds for investment by external borrowing without increasing domestic saving, but are likely to be forced to pay higher interest rates if they do so. The higher interest rates reflect a premium lenders require to compensate them for country-specific risks.

Applying this perspective to New Zealand means that a lower saving rate by New Zealanders would increase domestic interest rates to some degree by increasing the demand for foreign loans. This rise in interest rates would reduce domestic investment. The fall in investment would, however, be much less than the decline in saving. Most of the decline in saving would be offset by increased foreign borrowing. Only a small portion of the decline in saving would come out of domestic capital.

Both the Harberger and Feldstein-Horioka studies used data from the 1960s and 1970s. Studies using more recent data could strengthen the case for Harberger's "world market" perspective to the extent that barriers to capital

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<sup>81</sup> Martin Feldstein and Charles Horioka, "Domestic Saving and International Capital Flows," Economic Journal. June 1980.

<sup>82</sup> Arnold C. Harberger, "Vignettes on the World Capital Market," American Economic Review. June 1980.

mobility have lessened in the 1980s.<sup>83</sup> Studies to date, however, have failed to refute the Feldstein-Horioka finding of a high correlation between domestic investment rates and national saving rates and have been unable to attribute their finding to an alternative behavioural assumption.<sup>84</sup> The continued evidence of this correlation between domestic saving and domestic investment, in a world with considerable movement of capital across borders, is difficult for economists to explain.<sup>85</sup>

In conclusion, the view of the world as an integrated capital market is highly plausible. Such a world view would imply that changes in the domestic saving rate in a small country would have little if any effect on domestic investment. The observed correlation between domestic savings rates and domestic investment rates among countries suggests, however, that capital may be less mobile internationally than appears to be the case. If so, a decline in the saving rate in New Zealand would also reduce domestic investment.

### 4.3 Domestic Investment and Economic Growth

As noted above, even if the reforms in this Document reduce domestic saving - a result that is improbable for several reasons - they still may have only a minor effect on domestic investment. Because there may be some adverse effect, although minor, on investment, the final linkage considered here is that between investment and economic growth.

Economists have had difficulty explaining a large component of the growth in output by changes in direct productive inputs, such as labour and capital. A significant proportion of output growth cannot be explained statistically and is attributed to a residual of unmeasured factors believed to include technological change, better production methods and improvements in resource allocation. There is some evidence, however, that technical change itself may be positively related to investment, especially if investments are the vehicle through which new technologies are introduced and disseminated.

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<sup>83</sup> These barriers have been reduced substantially in some countries. For example, Australia and New Zealand eliminated exchange controls in 1983 and 1984, respectively.

<sup>84</sup> See, for example, Michael Dooley, Jeffrey Frankel, and Donald J. Mathieson, "International Capital Mobility - What Do Saving-Investment Correlations Tell Us?" IMF Staff Papers. September 1987.

<sup>85</sup> Dooley, Frankel, and Mathieson's explanation is that debt capital flows freely among countries, but inter-country movements of equity capital are limited and equity and debt are imperfect substitutes in investors' portfolios. This means that higher domestic saving can increase domestic investment, even if it does not lower the yield on debt instruments. Others explain the correlation as reflecting a policy by countries to prevent large changes in current account balances. Such a policy would also maintain a balance between domestic investment and national saving. See Lawrence Summers, "Tax Policy and International Competitiveness", paper presented at Conference on International Aspects of Fiscal Policies, Cambridge, Massachusetts, December 13-14, 1985.

Although a significant portion of economic growth cannot be explained by measurable factors, a faster rate of capital formation does increase economic growth. In a review of studies of economic growth, Boskin concludes that these studies suggest that the rate of capital formation and technical change have been important determinants of long-run growth in the United States. He also notes that these factors help to explain differences in productivity growth among countries.<sup>86</sup> While economists may disagree on the relative weight to assign capital formation and technological change in explaining growth, it is not disputed that higher investment rates will raise economic growth rates for many years.<sup>87</sup>

Any policy that retards domestic investment will by itself reduce the rate of growth in output and productivity by lowering the growth of capital per worker. On the other hand, if the same policy promotes a more efficient allocation of the capital stock, it will increase productivity per unit of capital. Thus, a policy that lowers total investment but results in a more efficient allocation of capital may either increase or reduce the growth rate.

It is unlikely that the reforms discussed in this Document will have an adverse effect on total investment. They are likely to improve the productivity of the capital stock by ending the artificial diversion of capital to tax-favoured activities. Thus, on balance, the proposals in this document will probably increase economic growth. There is a very low probability that they would do otherwise.

## 5 Conclusions

This appendix has reviewed the channels through which the reforms outlined in this document could adversely affect saving, investment and economic growth. In order for the proposals to have an adverse effect on economic growth, the following five conditions would need to be met:

- the reforms increases the overall tax rate on capital income;
- a decline in the after-tax return reduces private domestic saving;
- a decline in domestic saving reduces domestic investment;
- a decline in total investment reduces economic growth;

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<sup>86</sup> Michael J. Boskin, "Tax Policy and Economic Growth: Lessons from the 1980s," Journal of Economic Perspectives. Fall 1988.

<sup>87</sup> In standard neoclassical growth models, the long-run balanced growth rate depends only on the rate of growth of the labour force and technical change. An increase in the investment rate, however, will shift the economy from one growth path to another that may be characterised by permanently higher consumption per capita. During the transition period, which could last many years, the rate of growth will be higher than previously.



- the decline in total investment reduces productivity more than the improvement in the allocation of investment increases it.

The first condition - that the proposal increases the overall tax rate on income from capital - would occur only if the inflation rate fell to zero or very close to zero. The elimination of exemptions by themselves increases the tax rate on income from capital, but this increase is more than offset by the tax reduction resulting from indexation of the cost of assets at moderate rates of inflation. If the inflation rate were very low, indexation would have no effect. But then the tax rate on income from capital would be lower than it is today, even without the proposed changes.

If it were decided that only the elimination of exemptions and not indexation were to become part of the tax law, there would in all probability be only a small increase in the total tax rate on income from capital and a slight decline in the average after-tax rate of return across all assets. In that event, the other four conditions would have to hold in order for the reforms to affect economic growth adversely. This appendix has reviewed the findings of economic research on each of these four conditions. This review indicates that:

- an increase in the tax rate on income from capital may reduce private saving under certain assumptions. But neither economic theory nor empirical research to date provide definite confirmation that a decline in the after-tax return will reduce saving. Moreover, under certain circumstances, saving may even increase because an increase in the effective tax rate on income from capital, if offset by a revenue-neutral reduction in marginal tax rates, would redistribute wealth from the retired, who have relatively low saving rates, to younger members of society who save more. If the increased revenue were instead used to reduce the government deficit, national saving would in all probability increase even though private saving would fall;
- a significant portion of any decline in private saving will be offset by an increase in offshore borrowing instead of private investment. Because New Zealand is a small part of an international capital market, the saving of New Zealanders may have little effect on the cost of capital to New Zealand businesses;
- there is disagreement within the economics profession on the relative importance of technical change and capital investment in explaining economic growth. Still, if there is a decline in the rate of investment, it will have some adverse effect on the rate of growth; and
- even if the proposals reduce total investment, the improvement in the composition of investment could increase economic growth more than the decline in total investment reduces it.

In broader terms, therefore, there is no basis for concluding that the reforms outlined in this document would reduce total saving and investment. At the same time, the reforms are likely to improve the allocation of capital and thereby increase the productivity of the capital stock. Concerns about effects on overall capital formation do not justify maintaining the special exemptions for selected forms of income from capital.

## APPENDIX 2

### CONCLUSIONS OF PREVIOUS REPORTS IN NEW ZEALAND THAT RELATE TO THE TAXATION OF INCOME FROM CAPITAL

This annex contains extracts from previous reports that have addressed the issue of income from capital.

#### 1 THE REPORT OF THE NEW ZEALAND TAXATION REVIEW COMMITTEE, CHAIRED BY SIR LEWIS ROSS (THE "ROSS COMMITTEE") OF 1967.

##### "CAPITAL GAINS

983. On grounds of equity there is strong justification for taxing realised capital gains. However a decision on whether or not to tax capital gains should not rest on this principle alone. The problem is a complex one, involving quite formidable difficulties of definition and administration. The Committee has given a great deal of consideration to the question of recommending the introduction of a capital gains tax in New Zealand; although we have finally decided against such a recommendation, the matter is of such importance that we record our views in some detail, and outline the manner in which a capital gains tax could operate.

##### General comment

984. A capital gain may be said to have occurred whenever a capital asset increases in value. There is a distinction between a realised gain arising from the sale or disposal of an asset and an unrealised gain arising from an increase in value of an asset which continues to be held. There is a further distinction between the increase in the value of the assets in money terms and the increase after allowance has been made for inflation. Under the present taxation system in New Zealand there is a fundamental difference between gains of an income nature and those of a capital nature; only the former are assessable for tax. However, section 88(1)(c) of the Land and Income Tax Act 1954 provides that certain profits on sales or other dispositions of real or personal property, which otherwise would be of a capital rather than an income nature, are deemed to be income and assessed for tax as such. The exclusion of capital gains from tax is not provided for in legislation, and the terms "capital" or "capital gains" are not defined therein, but the principle of the exclusion is clearly established by decisions of the Courts. Capital assets that may

appreciate in value include land, durable property of all kinds, and shares and securities. In addition there are many types of gains not arising from sale or assets which could be treated as capital gains; these include compensation for loss of office, proceeds of life insurance policies, gifts, legacies, and lottery winnings.

985. Capital gains may arise from such diverse origins as speculation, the increased earning power of a business resulting from investment of profits, or effective management, and external forces such as population growth or economic expansion. Often the individual may show a certain skill in acquiring the capital gains for himself but it is much more often a matter of acquisitive shrewdness or good luck than for real contribution to economic welfare. There is thus a case for the State claiming a proportion of such gains, but there are associated problems of administration and distinction between realised and unrealised gains. Because of the formidable problems of valuation and administration it would involve, the taxation of unrealised capital gains cannot seriously be considered.

### **Capital gains taxes in other countries**

986. We have studied the operation of capital gains taxes in a number of countries and find that the systems used can be grouped in three categories. There are:

- All capital gains taxed whether short or long term.
- Capital gains by businesses taxed and gains by individuals if realised within a specified period.
- Capital gains by businesses alone taxed.

In this context the term business includes companies, partnerships, sole traders, and the professions.

### **All capital gains taxed whether short or long term**

987. In the following countries all capital gains are taxed when realised (but not otherwise), though in every case a lower rate of tax is applied to long term than to short term gains.

United Kingdom	India
United States of America	Ceylon
Denmark	Some Swiss cantons

988. In the United Kingdom a capital gains tax was introduced by the Finance Act 1965. Only realised capital gains attributable to the period after 6

April 1965 are liable for the tax. Net capital gains of persons other than companies are chargeable to tax at a rate of 30 percent. Gains which arise from the disposal of assets within 12 months of their acquisition are chargeable to income tax (and surtax) as unearned income of the year. Net capital gains of companies are included in the total income of a company for corporation tax purposes, no distinction being made between short-and long-term, gains. Certain assets are exempt from the tax, including a principal private residence, chattels worth less than £1,000, private motorcars, and National Savings securities.

989. In the United States of America income is defined to include any realised appreciation in the value of assets whether used in the course of business or not. The present system of taxing capital gains in the United States:

- Accords different treatment to the capital gains of corporations and of individuals.
- Distinguishes between gains made on property held for longer than six months and other gains.
- Accords more favourable treatment to long-term gains and imposes a maximum tax rate of 25 percent.
- Contains exemptions for special categories of property and certain transactions which are treated as tax-free exchanges.

#### **Capital gains by businesses taxed, and gains by individuals taxed if realised within a specified period**

990. In the following countries business capital profits are taxable but gains made by individuals are taxed only if realised within specified periods. These periods vary greatly and are generally longer for real estate and houses than for personal property such as stocks and shares or pictures:

Germany	Sweden
Austria	Some Swiss cantons
Luxembourg	

In nearly all these countries the rate of tax on speculative gains is the same as that which applies to normal income. Allowance is made for speculative losses.

#### **Capital gains by businesses alone taxed**

991. This is the most common system of capital gains taxation in Europe, and with variations applies to the following countries:

Belgium  
Spain  
Finland  
France

Greece  
Italy  
The Netherlands

If a business sells a security or a piece of machinery and makes a capital profit on it, that profit is taxed.

992. In France tax is charged on capital gains which arise from a business or profession. The general method for computing business profits is to compare the value of the net assets at the beginning and end of the taxation period and adjust for additions to or withdrawals of capital. In this way any capital gains or losses on a sale or transfer or withdrawal of business assets are automatically brought into account.

993. In the Netherlands all capital gains or losses by business corporations are included in income. As far as individuals are concerned, capital gains (or losses) arising from a business or profession and profits (beyond a certain limit) from speculation are included in income and taxed accordingly. Capital gains arising from the transfer of an interest in a company or partnership are regarded as income if the transferor owned more than 25 percent of the capital at any time during the preceding five years. On the liquidation of a company any sums received by a shareholder in excess of his paid-up capital are treated as income.

994. In Belgium capital gains taken into account for taxation are:

- The gains (or losses) arising from an industrial, commercial, or agricultural enterprise or from the exercise of a profession, on the realisation of any of the assets or any realisation or depreciation in value which the taxpayer shows in his accounts.
- The distribution of capital received by a shareholder.

### **The case for taxing realised capital gains**

995. The principle of equity supports the taxing of realised capital gains. If it is accepted that any system of taxation should embody the principle of treating equally those who have equal capacity to pay then it is difficult to justify the exemption of capital gains from all forms of taxation while income from effort is taxed in full. This point was accepted by the Canadian Royal Commission on Taxation which summarised its view by stating that: "It is what you get, not how you get it, that should count for tax purposes".

996. Some taxpayers are encouraged by the absence of a capital gains tax so to arrange their affairs that what would normally be taxable income is converted to non-taxable capital gain. This erosion of the tax base throws a heavy burden on those taxpayers who, by reason of the source of their income, are not able to avoid tax in this way.

997. The absence of a capital gains tax tends to encourage the holding of assets for speculative purposes rather than for productive purposes. While substantial capital gains may accrue from risk-taking ventures which should be encouraged, it is possible that a significant proportion of capital gains may arise from speculative buying and selling of assets. In the United States of America for example, the largest single segment of capital gains tax appears to be paid by investors in the stock market. American experience suggests that as long as the rate of tax is not high, it does not have harmful effects from an economic viewpoint.

998. Elsewhere in this report we have pointed out the heavy income tax burden borne by individual taxpayers in the \$6,000-\$14,000 income range. We have recommended a new scale for individual taxpayers which would not only materially alleviate this burden, but would also reduce the amount of direct income tax payable by every individual. Obviously this reduction necessitates a widening of the tax base. As long as capital gains, except to the extent they are caught by section 88(1)(c), escape the taxation net there must remain a gap in the tax base the existence of which supports the argument for the adoption of a capital gains tax.

### **The case against taxing realised capital gains**

999. The introduction of a realised capital gains tax would cause administrative problems and would not remove many of the difficulties of definition which at present exist. The revenue yield would probably be low and would vary from year to year. The rise in capital values in a period of inflation represents to some extent illusory and not real gains. However, the rates of capital gains tax can be so framed as to take this into account. Capital losses could occur especially in times of falling prices. It would be necessary to deal with this situation by allowing such losses to be carried forward and set off against future capital gains. However some countries are able to reconcile systems of taxing capital gains, estates, and gifts. A capital gains tax could discourage risk taking and investment for growth.

### **A possible system for taxing realised capital gains**

1000. As we have already pointed out there are strong equitable grounds for levying a tax on realised capital gains. Perhaps on the grounds of strict equity, unrealised gains should also be taxed but the problem would arise of

finding a method of measuring accurately each year the appreciation or depreciation that had taken place in the value of capital assets. We think that this problem is in general incapable of satisfactory solution.

1001 One of the major problems is the definition of the categories of assets which should be subject to the tax. As stated earlier in this chapter various assets are exempt from capital gains tax in the United Kingdom, the United States, and other countries. Clearly trading stock must be exempted, as also should the principal private residence of a taxpayer and his chattels up to a certain value. Other assets, such as works of art, may require special treatment. The tax probably should apply to assets owned by New Zealand residents (whether companies or individuals) both inside and outside New Zealand and to assets within New Zealand owned by persons resident outside New Zealand.

1002 In some countries, capital gains of companies are treated differently from those of individuals. The Committee sees no reason for making any distinction in New Zealand and considers that if capital gains are to be taxed, corporations, both public and private, non-incorporated bodies, individuals, and trusts should all be treated on the same basis.

1003 The next point is the treatment of and distinction between short-term and long-term capital gains or losses. There is a strong case to be made in favour of taxing short-term gains at a higher rate than long-term gains, thereby recognising the normal continuing decline in money values. This factor should be taken into account in fixing the rates of tax. Gains which arise from the disposal of assets within 12 months of their acquisition should be taxed at a flat rate of 35 percent. Where gains arise from the disposal of assets after 12 months tax should be at a rate of 30 percent reduced by 2 percent for each complete year during which the asset had been owned by the taxpayer after the first year until a minimum rate of 10 percent is reached. Thus if a taxpayer holds an asset for 11 complete years the rate of capital gains tax levied on realisation at any time thereafter is 10 percent.

1004 If realised capital gains are to be taxed realised capital losses should be deductible. As they cannot be allowed as a deduction against income the proper treatment would be to allow them to be set off against current and future capital gains. In the case of the death of a taxpayer, capital losses which may have accumulated to his death could be set off first against unrealised capital gains and for the rest against the net value of the estate for death duty purposes.

1005 The mechanics of introducing the tax would not be simple. All assets would have to be valued as at a specified date, and the valuation, supported by a statutory declaration, lodged with the Inland Revenue Department. Once the values of all assets were established as at the specified date the tax would be levied on realised gains made thereafter, using as the base such value of the



cost price of assets acquired after that date. Cases of hardship might occur on the sale of assets arising out the problems associated with the initial valuation. For example the valuation of shares in private companies could present difficulties. Accordingly there should for a limited period be a relief from hardship clause with appropriate right of objection.

1006 It is clear from the foregoing that a realised capital gains tax is entirely different from existing income tax and would call for a separate Act. It should, however, be administered by the Inland Revenue Department. Those provisions of the Land and Income Tax Act 1954 (especially section 88(1)(c)) which deem certain profits, otherwise of a capital nature, to be income should continue to apply and specific reference should be made to this effect in any future Capital Gains Tax Act.

1007 The following is an outline of a possible capital gains tax:

- Only net realised capital gains should be taxed.
- Unrealised capital gains should not be taxed except that assets should be deemed to be realised on the death of a taxpayer. If the executor or trustee should sell all or any of the assets within a prescribed period after the date of death such executor or trustee should have the option of substituting the net sale price for the value assessed by the Commissioner for the purpose of levying capital gains tax at the date of death.
- Capital gains on realisation of all assets should be subject to the tax except those categories specifically exempted. Trading stock should be exempted as should also the principal private residence of an individual taxpayer and his chattels up to a certain value. There may be a need for special treatment for other assets such as works of art. The tax should apply to assets owned by New Zealand residents (whether companies or individuals) both inside and outside New Zealand and to assets within New Zealand owned by persons resident outside New Zealand.
- Corporations both public and private, non-incorporated bodies, individuals, and trustees should all be treated on the same basis.
- The rate to be levied on realised capital gains should be 35 percent in respect of an asset sold within one year of acquisition and thereafter 30 percent reduced by 2 percent for each complete year for which the asset has been owned by the taxpayer after the first year, until a minimum rate of 10 percent is reached.

- Realised capital losses should be allowed to be deducted from current and future capital gains. In the case of the death of a taxpayer, capital losses which may have accumulated to the date of his death should be deductible first from unrealised capital gains, and the balance from the net value of the estate for death duty purposes.
- A date should be fixed for the commencement of the tax and all assets valued at that date. Once the values of all assets are established at that date the tax should be levied on realised gains made thereafter, using as the base such values or the cost price of assets acquired after that date.
- There should for a certain period be relief from hardship clause with appropriate right of objection.
- If a capital gains tax were introduced a separate Capital Gains Tax Act should be passed, such Act to be administered by the Inland Revenue Department. It should contain all necessary administrative, penal and other provisions. Those provisions of the Land and Income Tax Act 1954 (especially section 88 (1)(c)) which deem certain profits, otherwise of a capital nature, to be income should continue to apply and specific reference to this effect should be made in the new Capital Gains Tax Act.

## **Conclusion**

1008 The Committee considers that the introduction of a realised capital gains tax is desirable on the grounds of equity provided the rates of tax are moderate as suggested earlier in this chapter. 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 by Government on the introduction, form, and structure of the tax.

## **Recommendation**

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."

## 2 THE REPORT OF THE TASK FORCE ON TAX REFORM, CHAIRMAN P M McCRAW, OF 1982

### INTRODUCTION

10.21 The Committee received a number of submissions advocating the introduction of a capital gains tax on equity grounds. Many countries, including most OECD members, impose a tax on realised capital gains which arise on the sale of assets other than those sold in the ordinary course of business which are subject to income tax.

10.22 In principle, there is no reason why capital gains (whether made by a business or a private individual) should not be taxed. Such gains increase taxable capacity in just the same way as does a gain on income account. The Task Force considers that failure to tax real capital gains is inequitable in principle, and is seen by many to be so. It has also been represented to the Task Force that failure to tax capital gains provides an incentive for funds to be diverted from productive activities to unproductive investments offering prospects of capital appreciation. While this argument has merit, and is very credible, the Task Force received no evidence that the diversion of funds in this way is of major proportions.

10.23 Despite the comments and observations above, the Task Force does not recommend the introduction of a capital gains tax at this time.

### The Measurement of Capital Gains

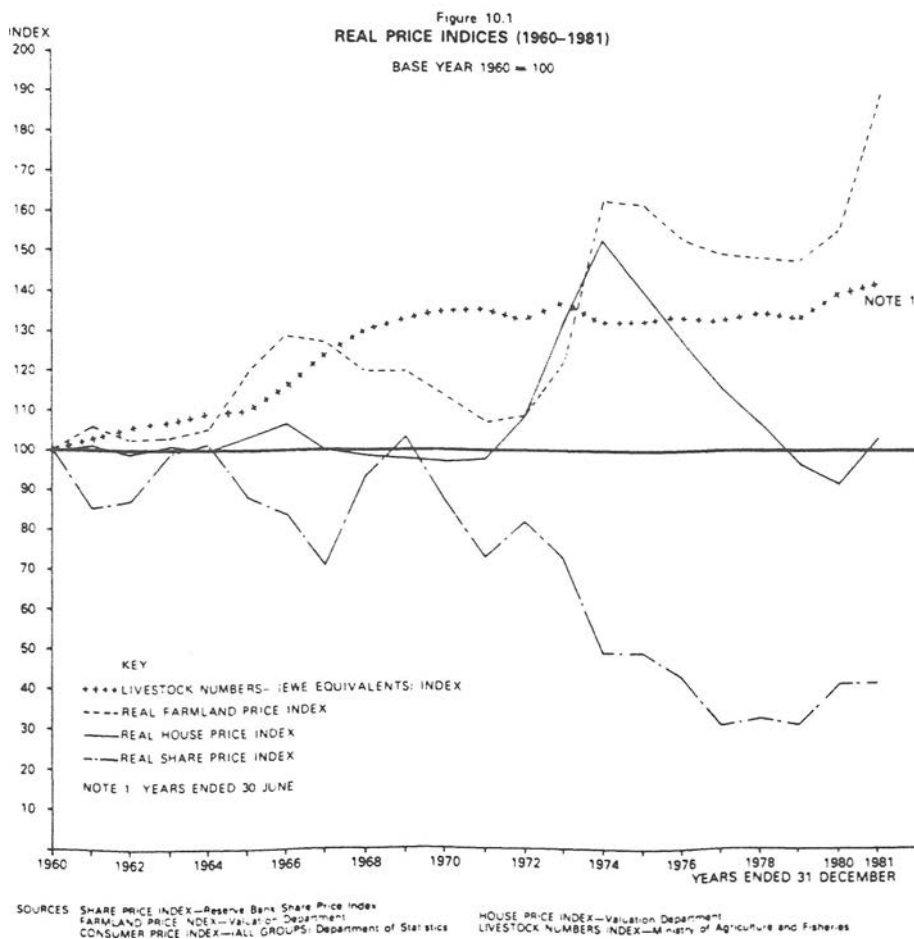
10.24 Real gains should be distinguished from nominal gains, especially when the times of purchase and sale of an asset are separated by a period of substantial inflation. A real gain will be made if the rise in price of the asset exceeds the rise in the general price level. To the extent that the transaction is financed by borrowing, a real gain may also be made even where there is no such excess in the rise in price of the asset itself.

10.25 Based on its study of real price trends, and on overseas experience, the Task Force is of the opinion that a capital gains tax would not produce significant revenue. It is recognised that there remains a question of equity but the Task Force is of the view that introducing substantial complexity for little revenue gain is not justified.

10.26 The Task Force considers that taxation of nominal gains in current New Zealand conditions would be wrong in principle. The introduction of a capital gains tax in a period of high inflation would probably bring with it more inequities than it would cure, unless the effects of inflation were also taken into account.

10.27 Nevertheless, many countries do tax nominal capital gains. Such taxes were introduced in times of relatively low inflation however when nominal gains would have approximated real gains. Even so, revenue from capital gains taxes is generally low in such countries despite the fact that their rates of inflation have since increased to high levels. For example, the yield from capital gains taxes in Canada was 0.8% of total tax revenue in 1978 and 0.9% in the United Kingdom in the same year. Yields in the United States are higher, being in excess of 1.9% of total Federal tax.

10.28 Real gains can be made on a wide range of assets including real estate, equity investments, and personal property such as antiques and art. In Figure 10.1, aggregate changes in the real value of listed public company shares and real property over the period 1960 to 1981 are shown, after deflation of the index by applying movements in the Consumer Price Index over the same period.



## **Gains on Company Shares**

10.29 The graph of real share prices indicates that aggregate capital gains on equity investments have been negative over the twenty year period. However, this does not mean that no capital gains have been made. Even in a period of generally falling prices, real capital gains will have been derived by some, either through the careful timing of purchases and sales or through investment in shares which have increased in value against the trend. Even so, under a capital gains tax, taxpayers would be able to defer the realisation of the gain, and, to neutralise it by realising capital losses on other investments. It is presumably this sort of arrangement that makes the revenue from the tax so small in countries which have adopted it.

## **Gains on Land**

10.30 Different considerations apply in respect of rural land. The potential has existed for the realisation of significant capital gains on the sale of farms as the real price of rural property has increased significantly (although not steadily) over the period. The last twenty years have seen three periods of sharp upward movement, two of which have been followed by a period of decline. That the third such period is still in the upward phase of the swing is apparent from the Rural Price Index to December 1981 (released in March 1982). This latest short term movement should not be viewed in isolation from the long term secular trend.

10.31 Many of the increases in real land values are probably related directly to certain incentives currently available to the business and agricultural sectors. For example, there is some relationship between the increase in farm prices and the increase in livestock units carried. The increased carrying capacity may flow from a specific policy decision to meet part of the capital cost (e.g. deduction for development expenditure). To the extent that such incentives are being applied in accordance with deliberate Government policy and are achieving clearly defined Government objectives, it would be inappropriate to tax benefits accruing as to do so would undermine the value of the incentive originally offered. If unintended benefits are accruing, the remedy lies in changing or modifying the incentive to bring it more in line with the intention of the incentive and, in particular, to ensure that costs to the taxpayer are not unreasonable in relation to the national interest and benefits accruing to the individuals concerned. This question, including the need for more effective controls and reporting procedures, is discussed in Chapter 4.

10.32 Substantial individual gains have no doubt been made on residential properties at some points during the period we have studied. On the other hand, the principal residence of a taxpayer is usually exempted from the impost of the tax, with the result that the capital gains tax revenue that would

have been derived from this source is probably small. Even what might seem a real gain on the sale of a principal private residence is to some extent illusory, because, generally, the vendor requires the proceeds to replace the property with one of a comparable standard.

10.33 Section 67 of the Income Tax Act provides a wide code for the assessment of profits made on the sale of land. In general, the transactions covered by the section are essentially of a revenue nature, such as profits made by those who deal in land, and those made where land is improved by the erection of a building or by subdivision. However, the section also includes a power to treat as income, certain profits made as a result of land price increases following a change of zoning or the like. Such profits may be considered to be more akin to capital gains than revenue gains. The Task Force is of the opinion that the breadth of this provision further reduces the need for a specific capital gains tax. The areas in which profits are being made on the sale of land should be continually monitored and where necessary, the section amended so as to maintain its effectiveness.

### **Borrowing Gains**

10.34 It is the view of the Task Force that most real gains arising from the sale of capital assets are made through financing the original cost in whole or part with borrowed funds. The taxation of borrowing gains in the business sector is fully discussed in Chapter 7 and, if implemented, would remove the most important taxation inequity associated with the gain on sale of capital assets.

10.35 Careful consideration has been given to the possibility of identifying and taxing borrowing gains in the non business sector. Significant problems were recognised, and no solution found. Both for personal taxpayers and in the business sector it would often be impossible to associate specific assets which have been sold with particular borrowings. To overcome this by assuming that the asset was purchased with funds that could have been used to reduce debt would almost certainly be regarded as unfair and would introduce serious calculation and administration problems. As non business interest is not deductible for tax purposes, the equity problem caused by the non taxation of private borrowing gains is considerably mitigated.

### **Conclusion**

10.36 The Task Force is not convinced of the need for a separate capital gains tax, and does not propose its introduction, even though capital gains are being made by some which should in principle be taxed. The adoption of the suggestions concerning determination of business income would substantially meet equity requirements."

### 3 THE REPORT OF THE CONSULTATIVE COMMITTEE ON ACCRUAL TAX TREATMENT OF INCOME AND EXPENDITURE, CHAIRED BY MR DONALD T BRASH, OF JUNE 1987.

#### "III INCOME V. CAPITAL

There are very strong theoretical grounds, relating both to equity and to economic neutrality, for making no distinction between "income" and "capital gains" for tax purposes. That no doubt explains in large measure why New Zealand is now the only OECD country which does not have some form of tax on capital gains.

At the same time, there are real theoretical, practical, and political difficulties in taxing capital gains, and that may explain why no other country has an entirely satisfactory capital gains tax.

There is for example, the question of whether the tax should be paid on accrued capital gains, or only on realised capital gains. If the former, imposition of the tax may create substantial cash flow problems. If the latter, a clear preference is created for the retention of fixed assets, and a significant "lock-in" effect created.

There is the question of whether the tax should apply to the full nominal extent of the gain, including the inflationary component, or just to the "real" gain. Taxing the full nominal gain might appear harsh, yet if the asset has been financed by borrowing, and the full nominal interest payment on that borrowing has been claimed for tax purposes, a compelling case can be made for taxing the nominal amount of the gain.

There is the problem of defining appropriate "borders" for the tax. If capital gain on land is included in the net, what about houses? If houses, what about large items of furniture, expensive art works, motor vehicles?

There is the problem of the actual introduction of the tax. Should taxpayers be exempt from tax on the capital gain on assets owned when the tax is introduced, and only taxed on the gain on assets acquired after the introduction of the tax? If so, a major preference is created in favour of those holding existing assets, and an undesirable "lock-in" effect. If not, the problem of determining the base from which gains are calculated is considerable.

And after all the problems are dealt with, international evidence suggests that the revenue to be raised through taxing capital gains is not large.

At the same time, these difficulties do not suggest we should totally ignore what is in reality income, and commonly regarded as such by most accountants and businesses. Thus, for example, there appears little merit in failing to tax

the profit on assets sold by individuals within 12 months of acquisition, or the profit on any assets sold by companies. (In logic, it is hard to see why any gain by a company can be regarded as other than "income".)



#### **4 THE REPORT OF THE CONSULTATIVE COMMITTEE ON INTERNATIONAL TAX REFORM, CHAIRED BY MR ARTHUR VALABH OF MARCH 1988.**

##### **"8.1 Role of a Capital Gains Tax.**

8.1.1. We have commented already on the possible role of a capital gains tax in the context of the present reforms. In many cases, the income that residents derive through offshore investments (apart from distributions) is best characterised as capital gain and, short of violating accepted income tax principles, is most appropriately taxed under a capital gains tax.

8.1.2. The lack of the comprehensive taxation of capital gains in New Zealand is the last outstanding gap in our tax system. The reforms that the Government has implemented over the last few years have gone a long way to broadening the tax base and addressing sources of avoidance. The first major base broadening measure was the introduction of GST. Within the income tax system, the next step was the removal of explicit tax concessions such as export incentives and accelerated depreciation provisions. The removal of such incentives in return for a reduction in tax rates is very much the central theme of current tax reform programmes in OECD countries.

8.1.3. The third set of reforms was the adoption of comprehensive accrual rules. These were aimed at countering tax planning based on the deferral of financial arrangement income or the advancing of tax deductions. The fourth and present set of reforms address the avoidance and deferral opportunities which arise in the international context. The Government has also moved simultaneously to reduce the avoidance problems which arise with the exemption of the superannuation funds and other entities.

8.1.4. The last major tax base problem is the general exclusion of capital gains from the definition of assessable income. There is widespread support amongst tax practitioners for the taxation of capital gains. The Committee endorses this view. Many of the remaining deficiencies in the tax system have their origin in or are compounded by the lack of a capital gains tax. The next step in the Government's tax reform programme should be to extend the tax base to include capital gains as soon as it is feasible to do so with the objective of facilitating a further reduction in tax rates.

8.1.5. New Zealand is the only country in the OECD which still has no general capital gains tax. Countries such as the United States, the United Kingdom, West Germany, France and Japan have all taxed capital gains for some time, while Australia introduced a capital gains tax in 1985."

**5 REPORT OF THE CONSULTATIVE COMMITTEE ON FULL IMPUTATION, CHAIRED BY MR ARTHUR VALABH, OF APRIL 1988.**

"6.2 Capital Gains Tax

6.2.1. One of the objectives of the CD is that all dividends paid out of retained earnings (whether or not they can be credited) are assessable in shareholders' hands. At present, since companies are prevented by the Companies Act 1955 from buying their own shares, the only way that retained earnings can be paid out to shareholders is by way of a dividend. If this restriction is removed, as proposed by the Law Commission, companies will be able to disburse their retained earnings by buying back their own shares.

6.2.2. Regulatory law, such as the Companies Act, must be framed according to its own objectives. The tax law should not need to rely for its effectiveness on unrelated statutes. Thus, the situation referred to above needs to be addressed within the tax legislation. One possible approach to the buy-back by a company of its shares, which is the present treatment in section 4 of the Income Tax Act, would be to tax as a dividend the difference between the paid-up capital attributable to a share and the purchase price paid by the company. This would not, however, be sufficient when a company formed or arranged for another company to buy its shares. Moreover, whenever a company uses retained earnings to buy shares in any company from an individual or other non-corporate shareholder, it is in effect distributing retained earnings. Thus, retained earnings leave the corporate sector tax free in the absence of a capital gains tax. It would not be practicable to tax gains on shares only when they were sold by an individual to a company. The only feasible approach is to tax all capital gains arising on the sale of shares.

6.2.3. In Part 1 of its Report on International Tax Reform, the Committee endorsed the Government's decision to give priority to the investigation of a capital gains tax. Changes to company law along the lines advocated by the Law Commission would reinforce the need to bring capital gains within the tax net."

## **6 THE REPORT OF THE ROYAL COMMISSION ON SOCIAL POLICY, CHAIRED BY SIR IVOR RICHARDSON, OF APRIL 1988.**

"In the last 20 years Canada, the United Kingdom, and now Australia have introduced capital gains taxes. The United States has always had one. Indeed, it began there as an amelioration of the treatment of such gains as ordinary income and in recent tax changes in that country there has been a return towards that position. New Zealand is out of the mainstream of current thought and practice in the area of capital gains taxation. Consideration of taxing capital gains must be on the social policy agenda.

The basic argument of principle in favour of taxing capital gains was succinctly put in the Draft White Paper on Reform of the Australian Tax System (1985):

Because real capital gains represent an increase in purchasing power similar to real increases in wages, salaries, interest or dividends, they should be included in any comprehensive definition of income. The case for taxing income in the form of capital gains thus follows from the general case for comprehensiveness in the definition of the income tax base and is similarly grounded in terms of the objectives of equity, efficiency and combating tax avoidance.

It is arguable that read literally the old New Zealand statutory expression including as assessable income 'all profits or gains derived from any business' extends to profits and gains in the form of capital gains. But traditionally New Zealand has not taxed such gains except for specific items treated as ordinary income such as certain land profits. Historically, the reason has been that in the administration of the New Zealand tax system we have followed trust law concepts. They differentiate the interests of the life tenant (entitled to income) from the interests of the remainder (entitled to capital and so to the proceeds of realisation of capital assets of the trust). So we see the familiar analogies of the tree and the fruit, and the land and the crop. With hindsight it seems surprising that concepts of trust law were considered an appropriate substitute for a direct focus on economic efficiency and equity concerns in the raising of taxes. In practice, too, the distinction between capital and income is often elusive or unreal and it has given rise to an immense amount of litigation.

But while there is some uncertainty as to drawing the line, it is the three objectives noted in the Draft White Paper - efficiency, equity and combating tax avoidance - that have led Australia and other countries to tax capital gains. Clearly, the exclusion of such gains from tax encourages tax planning designed to produce gains in that form. That process distorts economic decision-making and resource allocation. This is because there is likely to be greater investment in assets thought especially likely to appreciate in capital value. And recent changes in the economy and information technology, combined with increased emphasis on financial services, the stock market and commercial developments have perhaps highlighted this factor.

In terms of equity, the well-to-do who have substantial assets and are not so reliant on wages and other personal services income are generally better placed to make investments which yield capital gains. And those who derive their accretions to economic power in the form of gains not subject to tax pay less than those who achieve like gains in a taxable form. As a result, both horizontal and vertical equity aims are compromised.

There is a further element of potential unfairness where borrowed funds are employed to purchase assets in the anticipation of capital gains. The owner receives a tax deduction for the full amount of the interest paid without bringing into account the increase in value of that proportion of the asset representing the borrowed funds. And the interest rate itself often includes a capital allowance for inflation. As a consequence, borrowers expect to gain in real terms from holding these assets, in periods of inflation. If no adjustment is made for inflation, there is no recognition of the change in the debt/equity ratio in their favour, often resulting in inflationary times in a early shift of resources from lenders to borrowers. Of course, this does not guarantee that the value of the borrower's assets will in fact increase - as seen in recent months. Finally, there is an obvious erosion of the domestic tax base through the availability of the interest deduction in international transactions where funds borrowed by a New Zealand company are then employed overseas leading to the receipt by the New Zealand company of non-taxable dividends as the only form of revenue gain.

**Our conclusion is that viewed in terms of fairness (and economic efficiency) the argument for taxing capital gains is overwhelming**

If that gap in the comprehensive tax base is to be closed, various structural questions will require answer. The first is whether to tax capital gains as they accrue or only when realised. Australia, Canada, the United Kingdom and the United States, to name just four countries with capital gains taxes, have all chosen to tax on a realisation basis. Some erosion of the tax goals of equity, efficiency and neutrality must occur where tax is deferred until actual realisation. Deferral also results in some locking-in of resources and bunching of gains in the year of sale under a system of graduated taxation. But the liquidity problem of those who have insufficient cash resources to pay tax on unrealised gains, and the valuation, administration and political complications, have led other countries to opt for a tax on realisation.

Another set of issues relates to the treatment of involuntary dispositions, of assets held at death, of assets such as homes and farms and business assets exchanged for similar assets, of other personal assets and of assets held in trusts. Then there is the relationship between capital gains tax rates and ordinary income tax rates and possible differentiation between long-term and short-term gains - and the important question of whether the inflation element in gains should be excluded. Next there is the treatment of capital losses, in

particular the question whether they should only be offset against capital gains. Finally there are the implementation questions such as whether the new arrangements should apply to all gains realised after the introduction date, or only to the extent that gains have accrued after that date or only to gains in relation to assets acquired after that date. Capital gains taxes elsewhere tend to be quite complex and from the viewpoint of equity and efficiency there may be much to be said for the straightforward approach of taxing capital gains at ordinary income tax rates."

## **7 THE REPORT OF THE CONSULTATIVE COMMITTEE ON THE TAX TREATMENT OF SUPERANNUATION CHAIRED BY DR DONALD T BRASH, OF JULY 1988.**

### **4.1.3 Taxation of the Income of Superannuation Schemes**

"The consultative Document recommended that income derived by a superannuation scheme should be taxed as if it were being received by scheme members, the so-called "proxy concept". The Committee agreed with this basis of taxing fund income.

Notwithstanding this, the Consultative Document recommended that superannuation schemes should be liable to taxation on realised capital gains. As already noted, a great many submissions accepted the logic of having a capital gains tax in New Zealand, but almost without exception those who commented on this matter pointed out the inconsistency of applying a capital gains tax to gains realised by superannuation schemes while at the same time arguing that the income of such schemes should be taxed as if it were in the hands of members.

The Committee shares the view of the Consultative Committee on International Tax Reform and Full Imputation that an extension of the tax base to include capital gains would be consistent with the Government's general tax reform programme, and with the tax reforms being implemented by other western countries. At the same time, the desirability of such reform requires close analysis in the light of the practical problems involved, and in view of the fact that realised capital gains are not currently subject to tax in the hands of private individuals, we cannot support the recommendation in the Consultative Document that those gains should be taxable within superannuation schemes at this time."

**8 THE REPORT OF THE CONSULTATIVE COMMITTEE ON THE TREATMENT OF LIFE INSURANCE AND RELATED AREAS, CHAIRED BY DR DONALD T BRASH, OF AUGUST 1989.**

"2.8 Treatment of Unrealised Capital Gains

The Committee has consulted the Life Office's Association on the two new options that we have considered. The main policy issue raised by the Association was the appropriate definition of "policyholder distributions". Under both options, "policyholder distributions" are effectively defined in terms of policy claims plus any increase over the year in the life office's actuarial reserve, less premiums.

As the Association pointed out, those deemed distributions could be funded in part from "unrealised capital gains". The Association stated its opposition to this aspect on the following grounds:

- a it would impose an "unrealised capital gains tax" which would be contrary to accepted income tax principles;
- b other entities are not faced with this form of tax impost; and
- c the analogy with distributions is inaccurate in that companies would not normally make distributions from this source. If they were to do so, that could be effected by way of non-taxable bonus issues which would not incur a tax liability.

The Committee regarded this issue as being of considerable importance and therefore carefully re-considered the Option 2 proposal in the light of the Association's concerns. As noted above, our concern is to put forward a life office taxation regime which is compatible with the regimes applying to other entities but which meets the particular circumstances of life insurance.

The Committee's approach therefore needs to be justified on the grounds that it appropriately taxes distributions along the same lines as distributions made from other entities. Having considered this issue again, the Committee remains of the view that the approach can be justified on that basis. Although it would tax capital gains, realised or unrealised, on distribution, those are the taxation rules which also generally apply to ordinary companies. Whether a distribution from any particular source is or is not prudent is a matter which should be determined by shareholders subject to company law requirements.

We have concluded that an increase in an office's actuarial reserves is the closest possible approximation to normal corporate distributions. The closest analogy is to a taxable bonus issue. A company making a taxable bonus issue transfers income to shareholder capital. That is then taxable to shareholders as a deemed distribution with possible offsetting imputation credits.

The increased shareholders capital is then distributable in cash, subject to certain restrictions, tax-free. Similarly, under Options 1 and 2, an increase in a life office's actuarial reserves would be deemed a distribution which would be taxable. Under Option 2 the tax on the distribution could be offset by any available imputation credits. The amount in reserves would then be distributable to policyholders effectively tax-free.

Non-taxable bonus issues, on the other hand, are not analogous. For taxation purposes, a non-taxable bonus issue does not increase shareholder capital and thus does not increase the amount which a company can distribute to shareholders free of tax.

A second reason for defining policyholder distributions in terms of an increase in a life office's reserves is the long-term nature of life office business and the adoption of the proxy basis for the taxation of life offices. Those aspects allow a life office to provide returns to policyholders on the basis of any accrued increase in the value of investment assets while meeting claims (payable to policyholders tax-free) from other cash sources. Thus, if policyholder deemed distributions excluded any aspect of accrued investment gains, the tax on such gains could be indefinitely deferred even though they could still give rise to cash distributions to policyholders. That would not produce a position whereby life offices were subject to a taxation regime compatible with the regime faced by similar entities."



# APPENDIX 3:

## ANALYSIS OF LOCK-IN EFFECTS

### 1 Introduction

A tax on income derived on the disposal of assets results in a "lock-in" effect that reduces economic efficiency by impeding the transfer of assets among taxpayers. Lock-in occurs because taxpayers can defer payment of tax by holding onto assets instead of selling them and may under some circumstances avoid the tax liability entirely. This appendix considers the lock-in effect in more detail.

The appendix first reviews the general effect of an income tax. The lock-in effect is then defined, circumstances in which lock-in is likely to be a serious problem are described and empirical evidence relating to the size of lock-in costs in other economies is reviewed. Finally, policies to reduce lock-in costs for capital generally and for more narrowly defined asset categories are evaluated.

### 2 General Effect of An Income Tax

As noted in Chapter 3, an income tax generally applies only to income derived through market transactions. The exemption of non-market activities from the tax base means that an income tax discourages the sale of labour and capital services in the market place. An income tax therefore favours non-market activity over paid employment, home production over market production, and investment in houses and consumer durables over investment in business activities and financial assets. The lock-in effect of an income tax on income derived from asset disposals can thus be seen as one form of a more general phenomenon - the tendency of an income tax to discourage sales of goods and services (including capital goods) that generate taxable income.

Since it would not be practical to abolish income tax, economic policy must focus on minimising rather than eliminating these unavoidable effects. Because the significance of the distortions produced by an income tax depend importantly on level of tax rates, a key objective from an economic efficiency perspective is to reduce tax rates. A broadening of the tax base clearly facilitates this process. Thus, reducing rates and broadening the base go hand in hand and have been central elements of the Government's tax reform programme since 1984.

Provided tax rates are kept low, these distortions are not excessive because, in most cases, market activities and non-market activities are not close substitutes. In a complex, modern economy, most people specialise in a few activities and then trade with others in organised markets to obtain goods and services that they do not produce themselves. Thus, they cannot entirely avoid

a broad-based tax on market income from the sale of labour and capital services, although in some cases the presence of an income tax may make work effort, saving, and certain forms of investment less attractive than it otherwise would be.

### **3 Definition of Lock-In Effect**

The lock-in effect is the tendency of taxpayers to hold onto assets instead of selling them when income derived on the disposal of those assets is subject to tax. Lock-in occurs when assets that would have been sold if there were no tax liability on sale are retained by their owner.

The decision on whether to hold or to sell assets may be very sensitive to tax considerations. The market price of an asset generally reflects the present value of future services expected to be generated by the asset (whether or not those services are sold or consumed by the owner). If the asset is not sold, the owner can receive the market value in the form of the future services and can often borrow against the asset if he or she needs immediate cash. Thus, the cost to an owner of holding onto an asset he or she prefers to sell may be very small. Because holding and selling are closely substitutable activities, a relatively low tax rate on income on sale can induce large shifts in behavior.

### **4 Distinction Between Lock-in and Misallocation of Investment**

It is important to distinguish the lock-in effect from characteristics of a tax system that encourage or discourage investment in particular assets. The lock-in effect results from the fact that tax has not been paid as income accrues, so that disposal triggers a tax liability. In general, the size of the lock-in varies positively with the amount of tax payable as a fraction of the total sales price of an asset. In contrast, the decision to invest in one asset rather than another depends on a comparison of prospective after-tax returns from the two assets, given their anticipated holding periods.

The exemption of income on capital account under current law misallocates capital among assets because prospective effective tax rates are lower for assets that produce untaxed income than for those that produce ordinary income. There is, however, no lock-in effect when income derived on disposal is exempt because a disposal does not affect the vendor's tax liability. Imposing a tax on this income reduces the allocative efficiency loss. It does not eliminate it because the deferral of tax until disposal means that assets that produce income on disposal will continue to be favoured (although less so than at present) over assets that produce ordinary income. At the same time, a tax on disposals introduces a lock-in effect. This can only be avoided by not taxing

such income or by taxing it as it accrues. Thus, while the taxation of income derived on asset disposals would improve the allocation of investment among assets, it may result in an inefficient distribution of ownership of the assets created by that investment.

In short, lock-in results in what may be termed a loss of "exchange efficiency." Because an income tax on disposals impedes some disposals that would otherwise have taken place, the capital stock will be allocated inefficiently among investors. That is, even if society as a whole is holding the right total amount of all assets, the total expected return from the capital stock could be greater if ownership rights to particular assets could be reallocated among individuals.

## 5 Transactions Subject to Lock-in

The lock-in effect does not apply to the sale of all assets. If a taxpayer buys an asset for resale, and does not attach much value to holding it for its flow of future services, lock-in will be small. Thus, a taxpayer in the business of producing and selling a particular asset is unlikely to hold onto it to avoid income tax. For example, a construction firm is unlikely to retain ownership of the buildings it constructs in order to avoid tax, although an investor in a building may avoid selling it under similar circumstances.

As noted previously, lock-in reduces economic efficiency only because it impedes the transfer of assets among taxpayers. If individuals would not want to sell an asset even if there were no tax consequences, there is no lock-in problem. Similarly, if individuals are willing to sell assets even if the income so derived is taxed, there is no lock-in problem. Thus, while the lock-in problem is likely to be limited to sales of certain types of assets - those that may be held for production of future income or consumption services - it does not necessarily apply equally to all potential sales of such assets.

For example, an individual may hold onto a house longer than he or she otherwise would to avoid paying the tax, even if it means not satisfying changed preferences for size, housing type, or location. To the extent that the tax discourages such sales, the housing stock does not provide the maximum benefit to society. On the other hand, if the individual's preferences and personal circumstances do not change such that he or she has no desire to sell, there may be no social cost from a tax that might otherwise discourage him or her from selling. Similarly, if the individual's preferences or personal circumstances change so markedly that he or she will sell and pay the tax, there will also be no social cost from the tax.

Finally, the degree of lock-in is likely to depend on what the seller intends to do with the proceeds of the sale. If the seller intends to purchase an asset with similar characteristics, the substitutability between the two assets is likely to be high and a relatively small tax rate could discourage the sale. On the other

hand, if the seller intends to purchase something entirely different, the degree of substitutability may be smaller and a tax may have less effect on the sale decision.

The foregoing discussion suggests that, with respect to any particular asset and its owner, four conditions are all likely to be required for lock-in to be a significant economic problem:

- the asset can be either sold to finance other purchases or held to produce a flow of future services;
- the asset is held by an individual who is not in the business of selling the asset and, more generally, does not frequently trade that type of asset;
- the value of the asset to the owner depends on the characteristics of the owner and the value to a particular owner is likely to change over time relative to the asset's market value;
- the seller intends to use the proceeds of the asset sale to purchase an asset that he/she regards as being a reasonably close substitute for the asset being sold.

## **6 Evidence of the Importance of the Lock-In Effect**

Evidence on the size of the lock-in effect can be found from a number of statistical studies in the United States. These have investigated the extent to which realisations of income that is taxable in the United States as capital gains are affected by changes in the marginal tax rate on realised gains. These studies have controlled for a large number of other factors believed to influence the amount of realisation in order to isolate the partial effect of changes in marginal tax rates. The data used in the studies are, however, not completely adequate for the purposes investigated and the results are subject to different interpretations. In general, the estimates of the effect of changes in tax rates on realised gains are quite sensitive to the way in which the overall statistical relationship between capital gains and all other variables is specified.

Researchers generally agree that changes in marginal tax rates have a large short-run effect on asset disposals and that there is substantial evidence that higher marginal tax rates also reduce disposals in the long run, although by a lesser amount. Historical data appear to confirm the results of more detailed studies of the behavior of individuals. Realisations of capital gain income in the United States were much higher relative to GNP in the 1960s and early 1980s when the rate of tax on capital gains was lower, relative to the tax rates on ordinary income, than in the 1970s, when the preference for capital gains was substantially eroded.

There is no consensus, however, on the magnitude of the long run effect. Some research suggests that lowering marginal tax rates on capital gains in the United States will increase realisations by such a large amount that revenue will increase. Other studies dispute those findings.

A further problem is extrapolating the United States studies to New Zealand. First, the United States taxes nominal, not indexed, capital gains. This means that in the United States tax as a proportion of the sale price of the asset, and so lock-in, is much greater. Second, the United States allows gains passed on at death to escape tax entirely by allowing the beneficiary to "step up" the cost basis of the asset to its market value when inherited without paying tax on the accrued gain. If either accrued income was deemed to be realised and taxed at death or, alternatively, if beneficiaries were required to take the decedent's capitalised cost transferred assets, the lock-in effect would be smaller.

Studies from the United States have analysed lock-in effects the when marginal tax rates on nominal capital gains varied from 20 to 40%. While these studies do not lead to firm conclusions about the tax rate of which lock-in becomes significant, they suggest that full inclusion in the tax base of income derived or the sale capital assets might have had significant efficiency costs if income tax rates were near the top of this range, particularly at high inflation rates.

Thus, under the New Zealand income tax rate structure, lock-in should not be a serious problem, particularly if income from capital is indexed, if the broadening of the tax base continues and if marginal tax rates decline further.

## **7 Lock-In Relief**

A number of other countries provide special lock-in relief in the form of exemptions and/or non-recognition of income on disposal (so called "rollovers") for defined asset categories. For example, all countries with capital gains taxes provide concession for sales of personal residences. In addition, there are widespread provisions that allow exemption or deferral of capital gains tax on sales of farms, on sales of small businesses and for certain transactions defined as "like-kind" exchanges.

Special measures targeted on such assets may be defended on efficiency grounds if it is believed that lock-in is a serious problem for those particular assets and that they might be more subject to lockin than assets generally. In particular, substitutability may be larger, and therefore potential lock-in costs greater, if the taxpayer intends to use the proceeds of the sale of an asset to purchase a similar type of asset. Thus, some may argue that economic efficiency can be enhanced by allowing a deferral of recognition of part or all of assessable income if the proceeds of an asset sale are used to purchase an asset in a similarly defined asset category.

Such treatment has, however, major disadvantages and may in some circumstances increase, rather than reduce, lock-in costs. While rollover reduces lock-in for the narrowly-targeted transaction, it increases the extent to which the investor is locked into the defined asset category. For example, a rollover for personal residences eliminates any disincentive for an individual to move to a house of equal or greater value, but increases the degree of subsequent lock-in later in life when the same person may wish to "trade down" to a lower-valued residence and invest part of the sales proceeds in other assets. Lock-in to personal residences is increased because, by allowing the tax to be deferred to the extent that sale proceeds are reinvested in another residence, the tax liability on the eventual future sale of the residence increases as a proportion of the value of the residence.

An additional disadvantage of allowing rollover treatment is that it can result in such a long deferral of the tax liability that the liability is effectively eliminated for selected assets. Thus, the perceived lock-in costs would have to be substantial before special rollover provisions were justified.

Even if the efficiency costs were substantial enough to warrant special treatment, it is not at all clear that the case for concessions is established. A preferable solution may be to accrue part or all of the income as it is earned, rather than recognising it on disposal. There are a variety of methods which can be used to achieve this. It is not necessary for such methods to be accurate. Rather, it is only necessary that the valuation normally be more accurate than the current method of accruing no gain for assets that generally experience increases in real value.

## 8 Conclusions

Lock-in occurs because many taxpayers regard the sale of an asset and its continued ownership to be closely substitutable. Lock-in causes a loss in efficiency to the extent that assets are more highly valued in the hands of some owners than others. A tax on income derived when property is disposed of results in lock-in because the tax is triggered by the sale or exchange of the property, not as income is accrued.

The costs of lock-in vary among types of transactions. Lock-in costs are potentially greatest where:

- the asset produces a flow of future services;
- the asset is held by an individual not in the business of buying and selling that class of asset;
- the value of the asset varies among owners and the value to a particular owner can change relative to the market value; and

- the seller considers other assets he/she might potentially own instead to be close substitutes for the one that he or she might sell.

Partial relief from tax on disposal is sometimes advocated to limit the economic costs of lockin. Such relief can be of two types - general relief for a broad class of assets or targeted relief for particular transactions. Lock-in relief in the form of a preferential rate for a broadly-defined category of income from disposals is likely to increase economic efficiency only if realisations of such income are very sensitive to changes in effective marginal tax rates. While overseas research suggests that realised capital gains do increase when the marginal tax rate on gains is lowered, the extent of the estimated long-run realisations response varies so widely among studies that general inferences about the efficiency effects of a preference are difficult to make. Nonetheless, historical data from the United States does suggest that lockin may become severe when nominal income designated as capital gains is taxed at rates above the 25-35% range. Indexation of the tax base together with the taxation of all disposals would substantially lessen this problem.

In the absence of the detailed empirical information needed to calculate net efficiency effects, a strong case can be made for taxing income derived from the disposal of property at the same rate as ordinary income in spite of the lock-in effect. Arguments for exemptions of particular forms of income can always be made based on a presumed high rate of substitutability between that form of income and untaxed income. A series of discrete decisions to narrow the tax base on particular transactions can lead over time to the type of income tax system in effect prior to 1984 - one characterised by high marginal rates and a narrow tax base. If the trend towards lower income tax rates and a broader tax base that has characterised tax reform since 1984 is to be continued, and if the tax base is indexed, the arguments for measures to reduce lockin relief become weak.

In addition to a general preference, some may advocate special relief to reduce lockin of sales of personal residences, farms, or small businesses. Such relief may be take the form of either exemption or non-recognition of income. These concessions have major disadvantages, however, and the special circumstances under which they would increase rather than reduce economic efficiency are very difficult to identify.

To the extent that it is possible to do so, expansion of accrual taxation is always a better way of reducing lock-in costs than allowing preferential treatment for realised gains. Taxation of income on accrual both reduces lock-in costs and reduces the difference in effective tax rates between assets that increase in value and those that produce ordinary income.





INTERNATIONAL COMPARISON  
OF TAXATION OF CAPITAL GAINS

RULES	COUNTRY					
	UNITED KINGDOM	AUSTRALIA	UNITED STATES	CANADA	GERMANY	JAPAN
Rate	Same as ordinary income tax rates	Same as ordinary income tax rates	Same as ordinary income tax rates	Same as ordinary income tax rates	Same as ordinary income tax rates	Same as ordinary income tax rates; except for real property held for a period of 5 years or more taxed at 20% rate; 20% rate on net gains or 1% on gross proceeds from publicly-listed stock
General Threshold Per Annum	Net gains of less than £5,000 per year (1989/90 limit) are exempt; gains on business or family company on retirement are exempt within certain limits	No special exemption	No special exemption	Maximum lifetime exemption of \$100,000; \$500,000 for qualified farm property and shares of small business corporations; 33% of gain excluded from income (decreasing to 25% in 1990)	Capital gains tax does not apply to individuals other than special provisions mainly restricted to short-term or speculative gains;	No special exemption

**COUNTRY**

<b>RULES</b>	<b>UNITED KINGDOM</b>	<b>AUSTRALIA</b>	<b>UNITED STATES</b>	<b>CANADA</b>	<b>GERMANY</b>	<b>JAPAN</b>
<b>Holding Period</b>	No holding period	No holding period	No holding period	No holding period	6 years for roll-overs of certain fixed assets	Real property held for 5 years or more taxed at 20% rate, real property held for 5 years or less taxed at 40% rate
<b>Indexation</b>	Yes	Yes	No	No	No	No
<b>Treatment of Losses</b>	Capital losses deductible against capital gains only; losses may be carried forward indefinitely	Capital losses deductible against capital gains only; (losses on listed personal use assets can be offset against gains only on other listed personal use assets);	For individuals net capital losses are deductible against other income up to an annual limit of \$3,000 with losses carried forward indefinitely. For companies, capital losses deductible against capital gains only	33% of capital loss non-deductible, capital losses deductible against capital gains only; capital losses may be carried forward indefinitely and back 3 years	Capital losses are fully deductible against other income	Capital losses are fully deductible against other income, except losses from the sale of securities; losses may be carried forward 3 years and back 1 year

RULES	COUNTRY					
	UNITED KINGDOM	AUSTRALIA	UNITED STATES	CANADA	GERMANY	JAPAN
Assets Excluded	Private cars, principal residences, government securities held for more than 12 months, tangible movable assets disposed of for £3,000 or less	Motor vehicles, gambling income and losses; personal injury or damage claims; personal use assets (other than collectibles) with a value less than \$5,000; principal residences	None	None	Assets held by individuals for investment purposes	None; large exclusion for principal residences
Major Non-Recognition Provisions	Rollovers for assets used in a business, certain reorganisations; transfers between 75% group companies	Rollover of assets between companies in the same group, rollovers to wholly-owned companies; involuntary conversions; transfers between spouses	Rollover treatment for certain corporate reorganisations; rollovers for transfers to companies; partnerships and trusts; involuntary conversions; transfers between spouses; like-kind exchanges	80% (50% from 1990) rollover treatment for fixed assets, (100% for real estate) if the proceeds are reinvested in replacement assets within 2 accounting years after the asset is sold	Rollover treatment for certain corporate reorganisations; rollover for transfers to companies, partnerships and trusts; certain property dispositions (other than rental real estate) where a replacement property is acquired within a specified time;	Rollover for like-kind exchange if consideration received or paid is not more than 20% of the cost of the asset; certain real property including principal residences; any real property held more than 10 years if the proceeds are reinvested in depreciable assets

COUNTRY

RULES	UNITED KINGDOM	AUSTRALIA	UNITED STATES	CANADA	GERMANY	JAPAN
Houses	Principal residence exempt from tax	Principal residence exempt from tax	Gains on principal residence deferred if reinvested within 2 years; a one-time exemption for the first \$125,000 provided for taxpayers 55 or older	Principal residence exempt from tax	Principal residence exempt from tax	Gains on principal residence exempt up to a limit; remainder deferred if proceeds reinvested
Gifts and Bequests	Deferred liability on gifts; bequests exempt	Deferred liability on gifts and bequests	Deferred liability on gifts; bequests exempt	Generally taxable, except liability is deferred on gifts and bequests for transfers between spouses or where a farm is transferred to a child or grandchild	Gifts and bequests exempt from tax	Deferred liability on gifts and bequests

COUNTRY

RULES	UNITED KINGDOM	AUSTRALIA	UNITED STATES	CANADA	GERMANY	JAPAN
International	Tax imposed on world-wide income of residents; tax imposed on emigration of individuals and companies, non-residents generally are not liable for capital gains tax	Tax imposed on world-wide income of residents; tax imposed on emigration of individuals and companies of foreign-source capital gains; non-residents taxed on certain domestic-source capital gains	Tax imposed on citizens regardless of location of asset; nonresidents taxed on "effectively connected" income, including real property and certain real property holding companies	Tax imposed on world-wide income of residents; tax imposed on emigration of individuals and companies for foreign-source capital gains; non-residents taxed on certain domestic-source capital gains	Tax imposed on world-wide income of resident companies, non-resident companies taxed on certain domestic-source capital gains	Tax imposed on world-wide income of residents; tax imposed on emigration; non-residents taxed on property situated in Japan













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