Inland Revenue
Te Tari Taake

THE TREASURY
Kaitohutohu Kaupapa Rawa

POLICY AND STRATEGY

Tax Policy Report: Joint Report - Tax Working Group - officials' initial advice on potential tax reforms for Budget 2019

Date:	14 December 2018	**Report No:**	T2018/3429 IR2018/800
		File Number:	SH-13-7-8

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	Agree to discuss this report with officials at the Joint Ministers' meeting on 17 December	17 December
Minister of Revenue (Hon Stuart Nash)	Agree to discuss this report with officials at the Joint Ministers' meeting on 17 December	17 December

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
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Matt Benge	Chief Economist, Inland Revenue			

Actions for the Minister's Office Staff (if required)

Return the signed report to the Treasury

Note any feedback on the quality of the report	

Enclosure: No

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Executive Summary

The purpose of this report is to help you prepare for the TWG's final report

The Tax Working Group will provide you with its final report in late January 2019. In order to meet the Government's timeline for enacting any significant tax reforms by mid-2020, you will need to make final decisions on key elements of proposed reforms within two months of receiving the final report, so that Cabinet agreement can be sought in early April. This will be a tight timeframe within which you will need to make complex policy decisions.

To help prepare you for this decision-making process, this report outlines officials' initial high-level views on the key reform measures that are being considered by the Group. All of these measures were included in the Group's interim report and/or have been discussed in the papers prepared by the Group's secretariat that have been provided to you. This report also provides a suggested process and timeline for officials to assist you in delivering a package of potential tax reforms in time for Budget 2019.

We are scheduled to meet you on 17 December to discuss this report. We are seeking your guidance on the following issues to help us in developing further advice early next year:

1. **Objectives** – your primary objectives for a package of tax reform, including your objectives on how to use the revenue raised.
2. **Capital gains design options** – what further information you would like on these.
3. **Tax reform packages** – your initial views on the shape of a package of tax reform, including whether you would like welfare measures to become part of a package.
4. **Ministerial engagement** – your guidance on how best to engage with you, other interested Ministers, and Cabinet over the coming months on these issues.

Officials would support extending the taxation of capital gains…

The Group's chair recently announced that the majority of the Group supports extending the taxation of capital gains. We agree that a broad extension of the taxation of capital gains (excluding the family home) would likely meet a number of the objectives in the Group's terms of reference, particularly the objectives to improve the fairness, sustainability and integrity of the tax system. It would also reduce the extent to which tax settings bias investment decisions, and thereby likely lead to a more efficient allocation of capital in the economy.

The Group's terms of reference also directed the Group to have due regard for the efficiency of the overall structure of the tax system, and noted the Government's objective for the tax system to promote the long-term sustainability and productivity of the economy. There are some downsides for efficiency associated with extending the taxation of capital gains. These stem from the resulting higher levels of taxation of saving and investment, lock-in effects, and compliance costs. On its own, extending the taxation of capital gains is likely to have a negative impact on productivity and efficiency in the economy (as would almost any measure which raises a similar amount of tax revenue).

Overall, the advantages and disadvantages of extending the taxation of capital gains would depend on how it is designed and how the revenue raised is used. A summary of our current views on the core design choices is provided in a table at the end of this executive summary.

…if implemented as a package with other complementary measures

In order to address the efficiency and productivity objectives outlined in the Group's terms of reference, extending the taxation of capital gains would need to be part of a package including measures to support business investment and productivity.

Of the measures considered by the Group, we would recommend those outlined in the table below. These measures would all address significant inefficiencies in the structure of the tax system that are currently acting (or would act) to bias decisions.

We would recommend measures 2 to 4 whether or not the Government was considering extending the taxation of capital gains (subject to revenue constraints). However, they would also be an important business offset for extending the taxation of capital gains. In respect of measure 5, the case for residential rental loss ring-fencing, in particular, is much reduced if capital gains are taxed more broadly.

Policy measure	Rationale	Indicative 5-year revenue impact (from 2021/22)
1. Extending income tax to include realised capital gains (excluding the family home)	Increase fairness, sustainability and integrity of the tax system	+$10 billion
2. Allow businesses to claim depreciation expenses on buildings	Encourage more business investment and improve efficiency of investment	s9(2)(f)(iv)
3. Allow businesses to deduct expenses for "black hole" expenditure	Encourage innovation and entrepreneurship	-$0.12 billion
4. Allow businesses to keep losses when the owner changes	Make it easier for small companies to expand	-$0.24 billion
5. Remove residential rental loss ring-fencing	Recognising that gains would be taxed, this would reduce upward pressure on rents and increase efficiency	-$1.3 billion (preliminary estimate, likely to be lower)

Note: These fiscal estimates are highly uncertain, preliminary, indicative, and are subject to further refinement. Projected revenue from extending the taxation of capital gains is likely to be revised downward because of new data that has become available in the last week. The revenue would build up slowly over time and be volatile.

We consider that a package with these core elements would be cohesive and effective in contributing to the Government's overall objectives for the tax system. This package would:

- make the tax system significantly more progressive
- increase fairness through a more consistent taxation of capital income (horizontal equity)
- improve revenue integrity and sustainability
- increase incentives to develop land for productive purposes, and
- improve business tax to better support investment, innovation and productive risk-taking.

The Government has choices about how to use additional revenue raised

The above core package would leave room for remaining revenue to be used for other priorities. We would expect the above revenue-negative measures to have a revenue cost of around a third to a half of the revenue raised from extending the taxation of capital gains over the first five years. Depending on the Government's overall priorities, the remaining revenue

could be used for other revenue-negative tax measures, expenditure initiatives, reducing debt, or setting aside for future Budget decisions.

The Group's chair has announced that the Group has developed four illustrative revenue-neutral packages. Alongside the measures outlined above, two other changes considered by the Group as part of these packages are lifting the bottom threshold for personal income tax and increasing KiwiSaver subsidies.

The Group has not focused on personal income tax settings at middle-to-upper income levels, but the Government could consider investigating changes here if increasing efficiency and productivity is a priority.

In its interim report, the Group recommended that the company tax rate be kept under review, but that it should not be changed at this point. Reducing the company tax rate has advantages and disadvantages, but, again, could be considered if the Government wished to prioritise increasing productivity.

Officials recommend you begin to consider options now for how to use the revenue raised if a decision is made to extend the taxation of capital gains. However, we suggest you leave your final decisions until March, when you will have information about the updated fiscal outlook, the final reports of the Tax Working Group and the Welfare Expert Advisory Group (WEAG) and a clearer sight of other expenditure bids being considered at Budget 2019.

Officials recommend that any personal tax and/or welfare package is designed after Budget 2019

The Group's proposed personal income tax and KiwiSaver changes focus on distributional objectives. If the Government's objective is to target lower income households in particular, then including changes to welfare settings would likely be more effective than only making changes to personal income taxes and KiwiSaver.

The Government could announce tax reductions or some welfare measures at Budget 2019. However, officials would recommend delaying design decisions on personal tax and welfare settings until after Budget 2019. Deferring decisions would enable time to take account of the WEAG's recommendations and provide the necessary time to develop an integrated personal tax and welfare reform package.

The timelines for pre-legislative consultation and detailed design will be challenging

To enact legislation by mid-2020, the Government would need to make decisions on key elements of proposed reforms in April, then consult and decide on the details, and then introduce legislation by November 2019. Officials can meet this timeline. However, it requires consultation and decision making on a large number of detailed and interconnected issues in a short space of time. This timeframe would increase the risks of there being a need to make further legislative changes in future, which would impose higher uncertainty and compliance costs on taxpayers.

Because of these risks, officials recommend amending the proposed timeline, to introduce legislation in mid-2020 with effect from 1 April 2022. This would allow additional time for consultation and decision making, which would help ensure legislation is fit for purpose, well-understood, well-tested to ensure it achieves the Government's objectives, and workable.

Under either timeline, there would be significant administrative resource implications for Inland Revenue from developing and implementing comprehensive tax reform at pace.

Officials seek your guidance on how best to engage with Ministers and Cabinet

Officials plan to provide you with advice on where we agree and disagree with the Group's final recommendations when you receive the Group's final report in January. Our suggested approach for the months ahead is as follows:

Timing	Milestone
Late January	• Group submits its final report • Officials provide advice to Joint Ministers on Group's recommendations
February	• Officials report to Joint Ministers on: o Key design choices for extending the taxation of capital gains o Options for tax reform package measures • WEAG delivers its final report
March	• Final Joint Ministers' decisions on: o Key design choices o Tax reform package • Budget Ministers' meetings to agree key decisions for any Budget 2019 package
Late March	• Initial Cabinet consideration of key design choices • Cabinet decisions on initial response to WEAG final report and next steps
April	• Final Cabinet decisions on: o Government's response to the Group's recommendations o Design choices, for consultation in a discussion document o Tax reform package

In addition, the Ministry of Social Development is developing advice to the Minister of Social Development on a process for responding to the WEAG report, which will need to consider the approach taken to respond to the final report of the Tax Working Group.

Alongside this timeline, we recommend you hold workshops with your Ministerial colleagues on the Group's final report. Subject to your approval, officials can liaise further with your offices on the timing and content of these workshops.

Extending the taxation of capital gains: summary of officials' initial advice on key design choices

Note: We have denoted design choices where we think there could be a substantive difference between the views of officials and the Group with an asterisk (*).

Design choice	Officials' initial advice	Para no.
*Scope**	A broad range of assets should be included in the tax base (subject to specific exclusions, such as the family home). A narrower range of assets would reduce equity and create new tax distortions.	30
Effective date	All gains made after a specified date ("Valuation Day") should be taxed, regardless of when owners acquired their assets. Excluding gains made on assets acquired before introduction would create an unfair distinction between asset owners, increase lock-in, and reduce revenue in the early years of the tax.	37
*Phasing**	All assets should be included in the base from the same date. Staggering the introduction of different assets into the tax base would increase compliance and administration costs, and create temporary distortions and inequities in the treatment of different asset classes.	44
When to tax	Tax should apply when the ownership of an asset changes.	49
*Rollover**	Rollover treatment defers taxation in situations where it would be fairer (or more efficient) not to collect the tax. As a general rule, to maximise fairness and equity objectives and minimise long-term lock-in, officials are likely to err on the side of limited rollover.	52
Tax rate	Capital gains should be treated like ordinary income and taxed at a taxpayer's ordinary tax rate.	57
*Treatment of losses**	As a general rule, tax losses should be able to be offset against ordinary income, although some losses on specific asset classes may need to be 'ring-fenced' (so they can only be offset against other capital gains) in order to manage integrity risks.	61

Page 7 contains a full table of contents of the issues covered in this report, to direct you to particular areas of interest.

Recommended Action

We recommend that you:

a **agree** to discuss this report with officials at the Joint Ministers' meeting on 17 December

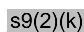
Agree/disagree *Agree/disagree*

b **indicate** your primary objectives for a package of tax reform

c **discuss** the key design choices for extending the taxation of capital gains and what further information you would like on these

d **indicate** your initial views on the shape of a package of tax reform and whether you would like welfare measures to become part of a package

e **provide guidance** on how best to engage with you, other interested Ministers, and Cabinet over the coming months.



s9(2)(k)

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Tax Policy Report: Joint Report - Tax Working Group - officials' initial advice on potential tax reforms for Budget 2019

Purpose of Report

1. This report outlines officials' initial high-level views on the key reform measures that are being considered by the Group. It also provides a suggested process and timeline for officials to assist you in delivering a package of tax reforms in time for Budget 2019.

2. The report focuses on the most fiscally significant tax policy changes that form the Group's proposed packages. Other changes recommended by the Group are not included – for example, environmental tax changes, where the Group's proposals have fiscal impacts that are uncertain and over the longer term.

Structure of Report

3. This report is split into the following sections:

Section	What is covered	Page no.

Extending the Taxation of Capital Gains	• The case for extending the taxation of capital gains on realisation
	• The key design settings in extending the taxation of capital gains, including the choices around:
	  o What to tax (e.g. land, business assets, intangible property)
	  o When to tax (e.g. upon realisation including the exceptions when deferral of the taxing point may be appropriate)
	  o How to tax (e.g. the rate of tax to apply and whether capital losses should be ring-fenced to capital gains)
	• Engagement with Māori
		8

Tax Policy and the Fiscal Strategy	• The projected revenue from extending the taxation of capital gains.
	• Three potential approaches to a tax reform package:
	  o Revenue-neutral
	  o Fiscally-neutral
	  o Revenue-positive
		17

Revenue-Negative Measures	• Revenue-negative measures that could be funded from the revenue raised from extending the taxation of capital gains:
	  o Personal income tax or transfers options, including:
	    s9(2)(f)(iv)
	    ▪ welfare transfers
	  o Business and housing measures, including:
	    ▪ restoring depreciation on buildings
	    ▪ depreciation for seismic strengthening costs
	    ▪ expanding black hole expense deductibility
	    ▪ reducing restrictions on loss carry-forwards
	    ▪ removing residential rental loss ring-fencing
	  o KiwiSaver measures, including:
	    ▪ decreasing lower KiwiSaver PIE rates
	    ▪ removing tax on employer contributions to lower-income KiwiSavers
	    ▪ increasing the Member Tax Credit
		20

Summary of Officials' Views	• Officials' initial views on package composition	28
Next Steps	• The timeline for legislation and the process for further advice	29

Extending the Taxation of Capital Gains

The Case for Extending the Taxation of Capital Gains

4. The case for extending the taxation of capital gains on realisation depends on the Government's objectives, how the tax is designed and how the additional revenue is allocated. The following section summarises the advantages and disadvantages of extending the taxation of capital gains on realisation, and the key design choices.

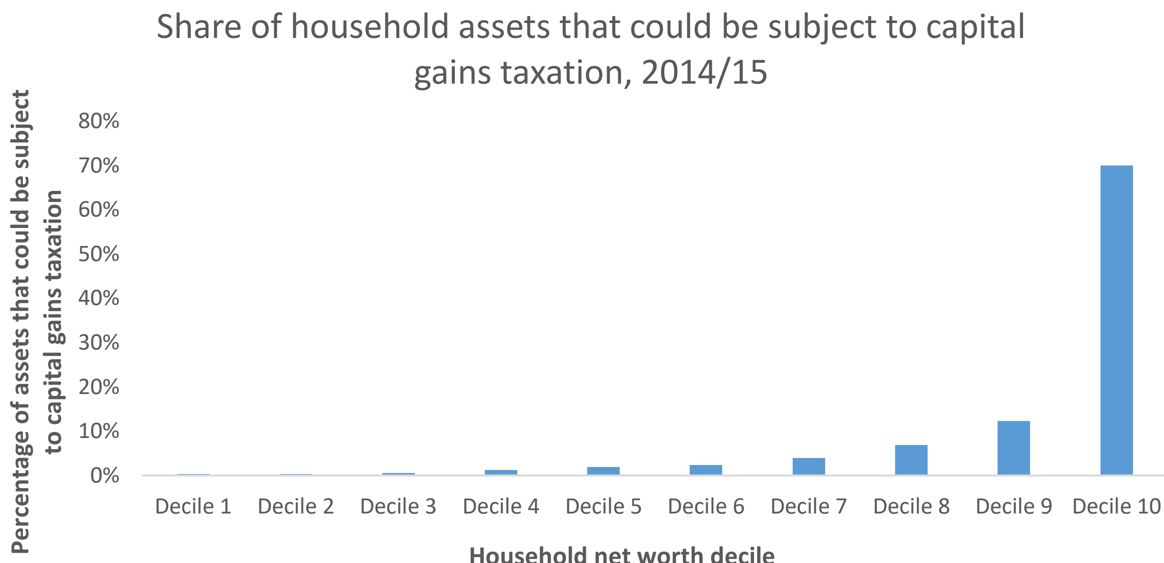
Advantages

Increasing the fairness of the tax system

5. Equity and fairness concerns provide the strongest rationale for extending the taxation of capital gains. Under current tax settings, people who earn income through capital gains pay less tax than those who earn the same amount of income from other sources. Extending the taxation of capital gains should help ensure they pay the same amount of tax, improving horizontal equity.

6. Extending the taxation of capital gains would also help increase the progressivity of the tax system, particularly with respect to wealth. Taxing more gains would likely lead to higher wealth individuals bearing a greater proportion of tax paid (see Figure 1 below). This is in line with your direction that the Group should consider packages that reduce inequality without increasing tax rates.

Figure 1:



Source: Statistics New Zealand (HES 2015) with subsequent Treasury calculations

Note: These estimates are based on the distribution of assets excluding cash, deposits and owner-occupied housing (proxy for assets subject to the taxation of capital gains).

7. Extending the taxation of capital gains would also be likely to increase the perception of fairness in the tax system. A sense of fairness is central to maintaining public trust and confidence in the tax system. A system that distributes the costs of taxation in a way that is perceived to be unfair will generate resentment and undermine social capital. Perceptions of unfairness erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance that underpins efficient tax collection.

Improving the integrity of the tax system

8. Extending the taxation of capital gains would support the integrity of the tax system, and bolster social capital, by reducing opportunities for tax planning and tax avoidance. Because capital gains are currently largely untaxed, there is a significant incentive for taxpayers to try to classify ordinary income as capital gains, in an effort to reduce their tax bills. Extending the taxation of capital gains should largely remove this incentive.

9. A particular integrity concern arises when there is a gap between the company tax rate and higher rates of personal income tax. New Zealand currently has a relatively small gap. The New Zealand model is for company tax to be levied at a rate of 28% on income accruing in companies, with a top-up tax of 5% of gross earnings when dividends are paid to shareholders on the top personal tax rate. However, in the absence of a capital gains tax it can be difficult to ensure that the top-up tax is paid. Extending the taxation of capital gains would help with current integrity pressures. The integrity benefits would be even greater if a future Government decided to increase the gap between the company and top personal tax rate.

Reducing the tax-bias in investment decisions

10. Extending the taxation of capital gains would help level the playing field between different types of investments (except the family home). By not comprehensively taxing capital gains, the current tax system creates a bias towards investing in assets that generate relatively more capital gains and less taxable income. This results in a misallocation of resources away from investments that primarily produce income that is taxable to the investor. Extending the taxation of capital gains would help address this misallocation of resources by increasing the neutrality of taxation applied to different investments. This would help with improving productivity and efficiency.

Sustainability of the tax base

11. New Zealand, like other countries, faces growing fiscal pressures from an ageing population. If the proportion of capital income relative to labour income increases, and capital gains remain untaxed, then it is possible that taxes on labour income will have to increase, or Government spending will need to decrease.

Revenue

12. Extending the taxation of capital gains would be likely to provide a growing revenue base for the future. Capital gains are the single largest source of income that most other OECD countries tax and that New Zealand largely does not. The additional revenue could be used to decrease taxes in other areas, increase welfare transfers, or allocate to other Government priorities.

13. While extending the taxation of capital gains would generate additional revenue, it would likely result in a higher level of volatility in revenue. The amount of revenue generated would be highly correlated with asset prices and the performance of the economy. Cyclical revenue could be supportive of economic stability (through the operation of the "automatic fiscal stabilisers") as the Budget Responsibility Rules allow for the operating balance to fluctuate over the economic cycle. However, greater revenue volatility would require disciplined fiscal management so that future Governments do not lock themselves into ongoing future expenditure commitments when revenue from taxation of capital gains is temporarily very high. We consider these risks can be managed.

Disadvantages

Creates a "lock-in" for investment decisions

14. Taxing capital gains only when they are realised creates an incentive for taxpayers to hold onto their assets for longer in order to delay the payment of tax on their gains. This

means that some economically efficient transactions that are currently occurring may cease to occur.

15. There have been many empirical studies of the significance of lock-in. While some have found that lock-in does not appear to be much of an issue in particular areas (e.g. with respect to the ownership and sale of portfolio shares), other more recent studies have found significant effects. However, it is difficult to know whether studies in one country are relevant for another because lock-in is affected by details of a country's tax provisions, including rollover relief.

16. Our view is that taxing capital gains when they are realised would create a lock-in effect, which would negatively affect economic efficiency. There are ways to reduce the negative effects of lock-in, but these are not without their own downsides. For example, rollover relief may at times remove lock-in. However, if the tax payable on capital gains is allowed to be rolled over, the size of the future capital gains tax liability will increase. This would increase the future longer-term lock-in effect, increasing the incentive not to sell the replacement asset (unless rollover were also available for that sale). Having limited rollover relief would limit the longer-term lock-in effect.

Increase in compliance costs

17. Extending the taxation of capital gains would result in an increase in compliance costs. These would be both one-off costs that would occur when the tax comes into effect, such as valuation of assets, as well as ongoing costs associated with the regime.

18. The ongoing compliance costs would mostly relate to valuation and record-keeping. Valuation issues would arise when certain assets are transferred between associated parties, or when they move in or out of the tax base. The ease of valuation would depend greatly on the type of asset: some, such as intangible property, are much more difficult to value than other assets, such as listed shares.

Increase in total taxes on investment and saving

19. Extending the taxation of capital gains would, effectively, be an increase in the taxation of savings and investment. Over a third of the additional revenue would likely come from the business sector. To the extent that this revenue reflected increased taxation of land, the impact on economic efficiency would likely be relatively limited. However, overall we would expect the higher tax burden to have a negative impact on aggregate levels of investment in the economy, which would likely flow through to lower levels of productivity.

20. Recycling revenue raised from extending the taxation of capital gains to measures that support business investment would be likely to support economic efficiency and productivity.

21. The long-term amount of revenue that is expected to be generated from extending the taxation of capital gains is relatively modest in the context of the overall size of the economy, at around 1.2% of GDP. However, the effect on some sectors and individuals could be significant.

Impact on the Housing Market

22. Extending the taxation of capital gains earned on residential property that is not a family home (discussed later in this report) could have an effect on both house prices and rents. Economic theory suggests that taxing these gains would put upward pressure on the rent-to-price ratio for residential housing. This could result in either an increase in rents, a decrease in house prices, or a combination of changes in both rents and prices.

23. There is considerable uncertainty about the effects on the housing market of extending the taxation of capital gains from residential rental property. It is expected to put some upward pressure on rents. There is more uncertainty about the effects on house prices,

although the impacts are not expected to be large in magnitude. The effects will depend partly on housing market demand/supply conditions and expectations of market participants when any policy is announced and introduced. The housing market impacts could be moderated with complementary tax policies to reduce costs for landlords and increase household incomes, discussed later in this report.

Officials' View

24. We consider that a broad extension of the taxation of capital gains (excluding the family home) would likely meet a number of the objectives in the Group's terms of reference, particularly the objectives to improve the fairness, sustainability and integrity of the tax system. It would also reduce the extent to which tax settings bias investment decisions and thereby likely lead to a more efficient allocation of capital in the economy

25. On its own, extending the taxation of capital gains is likely to have a negative impact on productivity and efficiency in the economy (as would almost any measure which raises a similar amount of tax revenue). While it would likely improve the allocation of resources in the economy, it would also increase the total level of taxation on saving and investment, create compliance costs, and introduce lock-in effects.

26. The overall effect of extending the taxation of capital gains on economic efficiency and productivity would depend on how the revenue raised is used. Using a significant portion of the revenue to make productivity-enhancing tax changes would be necessary if the goal is a tax reform package that improves New Zealand's productivity performance.

27. While there are some important downsides of a broad-based tax on more capital gains, other countries have wrestled with similar competing considerations and New Zealand is now the only member of the OECD, except for Belgium, without a formal, comprehensive regime in place for taxing the capital gains made by its personal and corporate residents.

28. High-level design details for extending the taxation of capital gains that have been considered by the Group are set out below, along with our initial high-level advice on those details.

Key Design Settings

29. The way in which a tax on capital gains is designed will have a major impact on the fairness and efficiency of the tax, compliance costs faced by taxpayers, and the effectiveness of the tax in generating revenue. The most significant design issues are discussed below. Areas where there may be some significant differences in opinion between officials and the Group are noted. We will provide you with a more detailed report on our view of the design arrived at by the Group when it delivers its final report to you.

What to tax

Scope

30. The Group's current view (as set out in its interim report) is that all of the following classes of assets should be subject to a tax on capital gains:

    a) Land (except the family home)
    b) Assets held by businesses
    c) Intangible property (all intangible property that is not currently taxed, unless it is held as a personal use asset)
    d) Shares and other equities (with specific rules for managed funds and foreign shares)

31. This would mean that tax would be collected on capital gains on almost all assets within New Zealand. The goodwill element of businesses will be captured by this list, either as

a business asset that is sold, or to the extent that goodwill is reflected in the value of a company's shares.

32. We agree that all of the assets listed above should be subject to the proposed taxation of more capital gains. Having a broad-based tax on capital gains would help ensure that the proposed tax would be both neutral, which would reduce the impact of the tax system on investment decisions, as well as fair, because taxing a broader base of capital gains is more in line with the principle of horizontal equity.

33. It is still possible to extend the taxation of capital gains to just a sub-set of the asset classes listed above. If you decided there should not be a tax on capital gains for all of the assets listed above, it would be possible to have a targeted tax that only included residential property that is not the family home. However, limiting the tax in this way would have significant implications both for the fairness of the tax (it would only apply to one form of wealth, so would not reach some that have significant wealth in assets such as closely-held companies) and for the revenue the tax would be expected to generate.

34. There are some types of assets that could be excluded from the scope of extending the taxation of capital gains. These are set out below.

Family home

35. There are a number of technical issues to work through in defining the family home. This is one area where the views of officials may differ at the margin from those of the Group, with officials tending to be more lenient than the Group mainly on the grounds of keeping compliance costs to a minimum.

Personal assets

36. In its interim report, the Group recommended that personal use assets, including cars, boats, non-business intangibles like personal insurance policies, and collectibles, including jewellery and fine art, should be outside of the base for extending the taxation of capital gains.[1] However, it also recommended that personal use land that falls outside of the family home definition should be in the base. This includes assets like second homes and baches. We agree with these recommendations.

Effective Date

37. The Group considered two possible options for how to start taxing assets after a tax on more capital gains comes into effect. One approach is to bring all gains and losses that occur from that effective date into the base (the Valuation Day approach). This would require all assets to have an assigned value from that date. The other approach is to only bring gains and losses on assets purchased after that effective date into the base (the grandparenting approach). This would allow the owners of assets acquired before the effective date of the tax to continue to make untaxed capital gains, as such assets would effectively be 'grandparented'.

38. In its interim report, the Group recommended the Valuation Day approach, and officials agree with this recommendation.

39. There is a large degree of private sector disquiet with the compliance costs associated with a Valuation Day approach. We agree that requiring all taxpayers to obtain a professional valuation as part of this process would be unreasonable. We consider there are low-compliance options that could be developed for all the major asset classes. This was also highlighted by the Group in its interim report.

40. The alternative grandparenting approach would have a significant negative impact on efficiency. It would create a substantial incentive for the owners of grandparented assets

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[1] Unless such assets would currently be taxable because, for example, they were purchased with the intention of resale for a profit, or were purchased as part of a business.

to hold onto those assets for longer than would otherwise be economically efficient, in order to continue to earn untaxed capital gains. This would exacerbate the lock-in effect created by taxing capital gains on realisation.

41. This approach would also be contrary to the principle of fairness. It would mean that people who are holding similar assets would be taxed differently based on when they acquired their asset, which is contrary to the principle of horizontal equity. It is also likely that taxpayers with lower levels of income and wealth would be more likely to have to dispose of grandparented assets quicker than other taxpayers. This would mean that taxpayers with higher levels of income and wealth would be more likely to continue earning untaxed capital gains for longer than other taxpayers. This would be contrary to the principle of vertical equity.

42. From a revenue perspective, grandparenting the existing asset base would likely raise less revenue than the Valuation Day approach. We estimate that the grandparenting approach would only raise 20% of the revenue in the first five years that the Valuation Day approach would raise. This gap would lessen over time (and eventually disappear altogether) as the churn of assets brought them into the base. According to Australian Tax Office officials, Australia still has a number of grandparented assets, despite the fact that their tax has been in place for over 30 years.

43. Although the grandparenting approach avoids the compliance costs associated with requiring assets to be valued on Valuation Day, it does require complex rules prescribing when assets may lose their grandparented status. Several Australian practitioners we consulted considered that the grandparenting approach created a lot of complexity in their law.

Phasing

44. Phasing relates to whether extending the taxation of capital gains on some asset classes could be delayed or staggered.

45. The main argument for some form of phasing is that extending the taxation of capital gains for some asset classes is more complex than for others. Having phasing would allow tax to be collected on the simpler asset classes at the same time as rules around the more complex asset classes are still being developed.

46. On the other hand, the phasing of asset classes would cause considerable problems. Staggered introduction would increase compliance and administration costs, and create temporary distortions and inequities in the treatment of different asset classes. It may also require the enactment of temporary definitional rules (to identify taxable assets) that would become redundant once the other classes were also subject to tax.

47. The Group has heard submissions from the managed fund industry that it would struggle to meet a 1 April 2021 effective date for taxing capital gains made within funds. Officials do not yet have a firm view on the scale of these concerns but this is something that could be considered as part of future public consultation.

48. If the Group were to recommend some broader form of phasing this is an area where we would disagree with its recommendation.

When to tax

Realisation vs accrual

49. The Group will be recommending extending the taxation of capital gains on the basis that the tax would only be imposed when a gain or loss is realised. This will usually occur when an asset is sold, but can also occur in other cases such as assets being gifted or rendered unusable. This approach would remove the cash flow and valuation issues

associated with taxing capital gains on an accrual basis (which the Group effectively ruled out for most asset classes in its interim report).

50. We agree that taxing on realisation is a better approach than taxing on accrual.

51. There are some specific situations where taxing capital gains on realisation will not be appropriate. For example, there are significant issues with having a realisation tax on shares held by managed funds. However, the application of this tax to the managed fund industry is an issue that will require significant consultation with the industry before we can provide you with a final recommendation.

Rollover

52. There will be times when the ownership of an asset changes when it would not be appropriate to collect tax on the resulting capital gain (or loss). This is called rollover treatment.

53. Rollover treatment is not an exemption from the tax, but merely a deferral of the taxing point. When rollover treatment is granted, the tax will still be collected at some point in the future. The gains (or losses) that accrued before the rollover event are rolled over and still subject to tax at a later sale.

54. Different countries have different principles for granting rollover treatment. As a general rule, officials consider that rollover should be relatively limited, because:

- rollover treatment reduces the revenue raised from the tax, as it allows the tax to be deferred until there is a realisation event that does not qualify for rollover. This could be in many years' time or potentially many lifetimes, if rollover treatment applies to death and gifts.
- some forms of rollover treatment may negate the fairness benefits that extending the taxation of capital gains is intended to provide.
- while rollover treatment reduces lock-in for an initial realisation event, it also leads to greater lock-in issues in the long term and may bias decisions on how firms reinvest.

55. Officials are of the view that rollover should be limited to the following situations:

- *Involuntary events* – A gain on an asset can potentially be realised due to an event outside of the control of the asset owner. Examples are when the Crown uses the Public Works Act 1981 to compulsorily acquire some land, or when an asset is destroyed due to a event outside of the owner's control, resulting in insurance proceeds being received. Our view is that these specific events should result in rollover treatment for the asset owner, provided that the proceeds from the realisation are reinvested into a replacement asset.
- *Business reorganisations with same economic ownership* – This rollover treatment would apply to business transactions that result in a realisation of assets but no change in ownership in substance. An example is when a sole trader decides to incorporate their business and put all of their business assets into a company. While the legal ownership of the business assets will change, the economic ownership has not. Imposing a tax on any capital gains in this situation could prevent economically efficient business reorganisations from occurring.
- *Relationship property transfers* – This rollover is provided when assets are transferred to a person's spouse, civil union partner or de facto partner (e.g., by way of gift or when the person dies). Many of these assets would already be considered jointly owned. Similarly, rollover should apply where assets are

transferred as part of a relationship property settlement (i.e., when a marriage, civil union or de facto relationship is dissolved).

56. To the extent that the Group recommends more generous rollover, we are likely to disagree with them.

How to tax

Tax rate

57. In its interim report, the Group recommended that, if more capital gains are taxed, they should be taxed at the taxpayer's marginal rate. We agree with the Group's recommendation. Doing this would allow capital gains income to be taxed like other forms of income in the Income Tax Act 2007, as opposed to being treated as a completely separate type of income. This is in line with the principle of horizontal equity.

58. Some countries choose to tax capital gains at a lower rate than ordinary income. Our view is that doing this would significantly increase the complexity around extending the taxation of capital gains. Taxing capital gains at a concessionary rate would also remove some of the horizontal equity benefits of extending the taxation of capital gains.

59. In saying this, we recognise that there are trade-offs to consider here. The higher the rates of tax on capital gains, the greater will be the inefficiencies associated with lock-in. We consider that our internationally low top personal tax rate provides scope for extending the taxation of capital gains at full marginal tax rates.

60. To the extent that capital gains are included in the ordinary "income" concept, we would expect that to also have a bearing on a person's social policy entitlements.

Capital loss ring-fencing

61. If it is decided to extend the taxation of capital gains, there needs to be a decision on how to deal with any capital losses that arise. There are a number of options available for the treatment of losses. One approach would be to allow capital losses to offset any other income, on the basis that the distinction between "capital" gains and losses and other gains and losses is arbitrary and capital gains and losses are just like any other form of income and taxed as such. A different approach would be to generally ring-fence capital losses so that they could only be used to offset other capital gains.

62. As a general rule, the more generous the rollover treatment, the more restrictive should be the treatment of losses. This is because rollover treatment provides the potential for taxpayers to 'cherry pick' by rolling over their gains and crystallising their losses. We advised the Group that there should be a starting presumption of no loss ring-fencing for all asset classes, with exceptions made as necessary. Ring-fencing losses would reduce symmetry in the tax treatment of capital gains and losses, creating a bias towards less risky investments. Introducing such a bias would have a negative effect on economic efficiency. However, there will be some reasons why loss ring-fencing is needed for specific types of assets. For example, in the case of the disposal of listed shares and other fungible assets, where losses can be crystallised at a relatively low cost and replacement assets immediately repurchased.

63. In the event that the Group recommends generous rollover and/or a restrictive use of losses, this is another area where we would disagree with its recommendations.

64. Allowing capital losses to offset ordinary income could pose a potential fiscal risk to the Government if asset prices were to decrease. Therefore, disciplined fiscal management would be required to manage future revenue volatility. Maintaining a strong Crown balance sheet would be important to ensure revenue fluctuations could be managed.

65. One specific asset class that requires particular attention is residential rental property. The housing market is currently constrained through barriers to supply,

primarily zoning restrictions and finance for infrastructure, with relatively low interest rates also contributing to high house prices. The Government is currently tackling the barriers to supply through its Urban Growth Agenda (UGA) which, if successful, will help make the housing market more competitive and could reduce house prices (although wider economic conditions such as the interest rate outlook and immigration will be important as well). Therefore, there is a fiscal risk that if house prices were to fall, there could be relatively substantial capital losses being claimed by investors in residential rental property. Without loss ring-fencing, these losses could be offset against investors' other income after the capital losses are realised.

66. The fact that investors are generally hesitant to realise a loss (that is, to sell a property for less than what they paid for it) should reduce the size of any potential fiscal risk if house prices fall. In addition, there are specific rules that can be utilised to mitigate this fiscal risk, on which we will advise you further in due course. It is also proposed that capital losses made on second homes and residential properties held for personal use be disregarded for tax purposes (see the following section). If these measures are adopted, on balance, our view is that ring-fencing capital losses made on residential property is undesirable from a tax policy perspective.

Second homes and baches

67. Under the proposed scope for extending the taxation of capital gains, all residential property (excluding the family home) would be taxed on any capital gain. However, there is an open question regarding how to treat capital losses made on residential property that is neither the family home nor residential investment property (i.e., second homes and baches).

68. Our view is that losses on second homes (homes that are not family homes or investment properties) are generally due to personal consumption. As with other losses arising from personal consumption, we recommend that these losses not be deductible against any other income.

Capital expenditure

69. Another issue is how to treat costs incurred on improving an asset after it was purchased (capital expenditure). Our view is that it is important that all capital expenditure be deductible from the sale price. Not doing so would mean that all spending that led to an increase in the value of an asset would become taxable. This would create a significant disincentive to improve an asset, even if it would otherwise be economically efficient to do so.

70. As a general point, we consider that the treatment of capital expenditure is a critical component of the design of extending the taxation of capital gains. One of the main justifications for the tax is that it will create better neutrality between various forms of income (horizontal equity). In order to be truly equitable, taxpayers should be entitled to deduct expenditure on capital assets to the extent that it is an actual economic cost. Not allowing these deductions could result in over-taxation of capital.

Engagement with Māori

71. The Group carried out five engagement hui with Māori in October to share information about key aspects of the interim report and to gain insights into possible impacts on transactions involving Māori collectively-owned assets.

72. This process identified a number of circumstances where extending the taxation of capital gains would likely result in outcomes that may not be consistent with the policy intent of the tax, possibly warranting specific treatment. The Group's final report will identify these circumstances and indicate how they should be treated under the proposed tax changes. These circumstances include, for example, transactions relating to Māori

Freehold Land and to recovery by Māori organisations of ancestral land that has been lost as a result of historic Crown action. Crown Law Office has provided legal advice that further analysis and engagement with Māori, informed by greater clarity about the key design features of proposed changes, should occur prior to taking decisions on treatment of these circumstances. This could occur as part of the Generic Tax Policy Process.

Tax Policy and the Fiscal Strategy

73. Potential tax reform should be consistent with the Government's wider fiscal strategy – for example, ensuring there is sufficient revenue to meet the Government's spending objectives to encourage a productive, sustainable and inclusive economy.

74. Tax policy decisions impact the outlook for revenue, depending on the decisions taken. Tax revenue is currently around 28% of GDP, and forecast to increase further owing to fiscal drag.[2]

75. Extending the taxation of capital gains is projected to increase tax revenue by around 1.2% of GDP after ten years, depending on the design details. Based on our understanding of the Group's likely views on design, this proposal would indicatively generate the following revenue:

Table 1: Projected revenue from extending the taxation of capital gains ($ billion)

Year	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
Residential investment	0.18	0.45	0.71	0.96	1.2	1.4	1.7	1.9	2.1	2.4
Commercial, industrial and other property	0.09	0.22	0.36	0.49	0.63	0.77	0.90	1.0	1.2	1.3
Rural property	0.07	0.17	0.27	0.37	0.46	0.55	0.64	0.73	0.81	0.89
Domestic shares not held by managed funds	0.16	0.39	0.57	0.71	0.83	0.94	1.02	1.1	1.2	1.2
Domestic shares held by managed funds	0.10	0.11	0.13	0.15	0.17	0.19	0.22	0.25	0.29	0.34
Total	**0.59**	**1.3**	**2.0**	**2.7**	**3.3**	**3.9**	**4.5**	**5.0**	**5.6**	**6.2**
% of GDP	*0.2%*	*0.4%*	*0.5%*	*0.7%*	*0.8%*	*0.9%*	*1.0%*	*1.1%*	*1.1%*	*1.2%*
% of total tax revenue	0.6%	1.3%	1.8%	2.4%	2.8%	3.2%	3.5%	3.7%	4.0%	4.3%

76. These projections of tax revenue are preliminary and indicative. Officials are continuing to refine the projections, and these numbers could be different by the time of Budget decision making. Our current expectation is that the net result of refinements to these projections will see overall downward revisions because of new data that has become available in the last week.

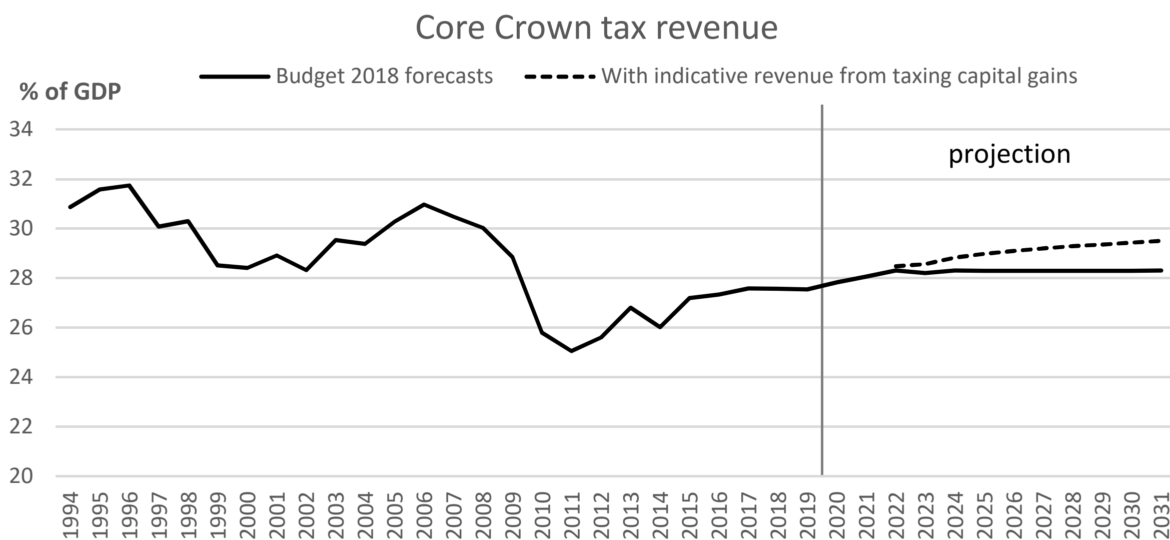
77. In addition, the projections are more uncertain than most other revenue projections because they depend heavily on assumptions about future movements in asset prices.

[2] In HYEFU, core Crown tax revenue is forecast to increase from 27.9% of GDP in 2017/18 to 28.9% in 2022/23. The rising tax-to-GDP ratio is largely driven by fiscal drag.

Actual revenue from extending the taxation of capital gains is likely to be volatile, with some periods having greater than projected revenue, while others could have less. There may be periods in which extending the taxation of capital gains could be revenue-negative, such as in an economic downturn. This inherent volatility in the revenue stream would require strong fiscal management to ensure additional revenue generated in periods when asset prices increase rapidly is set aside for the periods when asset prices fall.

78. That said, the total amount of expected revenue from extending the taxation of capital gains is relatively modest relative to GDP and total tax revenue. Figure 2 below shows a comparison between current projected tax revenue and projected revenue if more capital gains are taxed (with no offsetting tax reductions). The fiscal projections include a technical assumption that there is no fiscal drag in the projection period (beyond the five-year forecast horizon). However, if income tax thresholds are not adjusted, fiscal drag would add an additional $0.4 billion to $0.6 billion to revenue in each year.

Figure 2:



Source: The Treasury

Note: The projection of revenue from taxing capital gains is preliminary and indicative. Projections of core Crown tax revenue are based on the Budget 2018 Fiscal Strategy Report. From 2022/23, the fiscal projections assume that tax revenue is held constant as a share of GDP (ie, no fiscal drag). However, if income tax thresholds are not adjusted in the future, tax revenue would continue to increase as a share of GDP throughout the projection period.

79. The fiscal parameters of any tax reform package could be revenue-neutral, fiscally-neutral, or revenue-positive to enable higher spending in other areas. These options are discussed below.

80. Over time, the tax-to-GDP ratio would increase with fiscal drag, and therefore a revenue-negative package could also be considered as an option to stabilise the tax-to-GDP option, depending on your priorities.

81. Your views on the fiscal parameters for a package would help officials to provide advice on package options. Final decisions for a Budget 2019 package would be needed in March to take a proposal to Cabinet in early April. By March, you will have information about the updated fiscal outlook, the final reports of the Group and the WEAG, and a clearer sight of other expenditure bids being considered at Budget 2019.

Revenue-Neutral Package

82. Under a revenue-neutral tax package, all the revenue from extending the taxation of capital gains would be recycled into revenue-negative tax measures.

83. There are choices about how “revenue-neutral” is defined. The focus should be on ensuring that policy decisions are consistent with your overall fiscal objectives (i.e., the Budget Responsibility Rules).

84. Under the Group’s definition of revenue-neutral, the total revenue generated from extending the taxation of capital gains in the first five tax years (2021/22 to 2025/26) roughly matches the total cost of the revenue-negative tax measures over that same period. Since the revenue from extending the taxation of capital gains increases over time, the packages being considered by the Group are typically revenue negative in the early years. They would therefore be revenue negative over the Budget 2019 forecast period (2018/19 to 2022/23).

Fiscally-Neutral Package

85. Depending on the Government’s overall priorities, revenue could be used for a combination of revenue-negative tax, transfer or other expenditure initiatives.

86. There are different types of potential fiscally-neutral packages. One option is a fiscally neutral tax-and-welfare package, in which the revenue from extending the taxation of capital gains would be recycled into a combination of revenue-negative tax and welfare measures (welfare measures could include benefits and Working for Families tax credits). Higher tax revenue would help meet the fiscal costs of large welfare changes and considering personal tax and welfare changes together would improve policy outcomes (as personal tax and welfare systems interact).

87. There are options for sequencing tax and welfare decisions. One option would be to make decisions on welfare changes at the same time as decisions on extending the taxation of capital gains and introducing other revenue-negative measures. Changes to payment rates for existing benefits and/or tax credits could be considered in Budget 2019 because they do not require changes to primary legislation. The Ministry of Social Development is progressing three Welfare Overhaul initiatives for Budget 2019. However, there would be no time to develop an integrated reform of the tax-welfare interface in time for Budget 2019 that involved significant changes to the underlying settings of the welfare system such as changing eligibility settings.

88. Therefore, an alternative option would be to earmark a set amount of the revenue from extending the taxation of capital gains to put towards a future personal tax and transfer package. This approach would provide the Government with flexibility as to the timing of these decisions, while still ensuring that some of the revenue generated from extending the taxation of capital gains would go towards supporting low-income individuals. This option is not mutually exclusive from making some specific changes to welfare payments in Budget 2019. You could make some changes at Budget, while earmarking an additional amount for future welfare changes.

89. Once passed, the Child Poverty Reduction Bill will require the Minister of Finance to announce at Budget the impact of changes on child poverty. Changes to personal thresholds will not lift incomes of beneficiaries who are not in work, because tax changes do not lead to an automatic adjustment of benefits (as they do for New Zealand Superannuation and Student Allowance rates). Consequently, changes to personal taxation thresholds alone may not have any material impact on measures of child poverty, and for out-of-work families it could move them further away from the moving child poverty line, as the net median income rises. With an integrated tax and welfare

package you could consider the balance of impacts across poverty reduction, work incentives and fairness of the tax system at the same time.

Revenue-Positive Package

90. Under a revenue-positive package, a portion of revenue from extending the taxation of capital gains could be recycled into some near-term revenue-negative measures, but the remainder of the revenue would be left unallocated. This would provide more time and greater flexibility to consider the best way to use the expected revenue through the Budget process or pay down debt. This may be desirable given the time needed to consult, finalise and implement policy on extending the taxation of capital gains.

Revenue-Negative Measures

91. The Group is considering a range of revenue-negative measures as part of a tax reform package. The total cost of the measures exceeds the revenue from extending the taxation of capital gains. Therefore, the measures would need to be prioritised based on the Government's objectives to create a revenue-neutral package.

92. Below, we provide you with our initial high-level advice on the revenue-negative measures being considered by the Group, and other measures that could be considered. The measures are split into three categories:
    a) personal income tax or transfer options that focus on distributional objectives
    b) business and housing measures that focus on improving productivity and efficiency, and
    c) KiwiSaver measures that support low-income savers and which should more than compensate for the impact on them of extending the taxation of capital gains.

93. The indicative fiscal impacts of the measures below are based on assumptions about specific design features for the measures. Since there are a range of potential design alternatives for most of the measures, the fiscal impacts will change depending on the design choices made. In addition, officials will undertake further quality assurance of the final costings, which may change the results, and so they should be considered as indicative only. Many of these revenue estimates do not take into account wider economic or behavioural effects.

Personal income tax/transfers

94. The Group has considered personal tax changes that would increase the progressivity of the tax scale consistent with the Government's objectives outlined in your letter to the Group of 20 September. The Group has noted that transfers may be a more targeted tool to achieve the Government's objectives, but these are outside its terms of reference.

s9(2)(f)(iv)

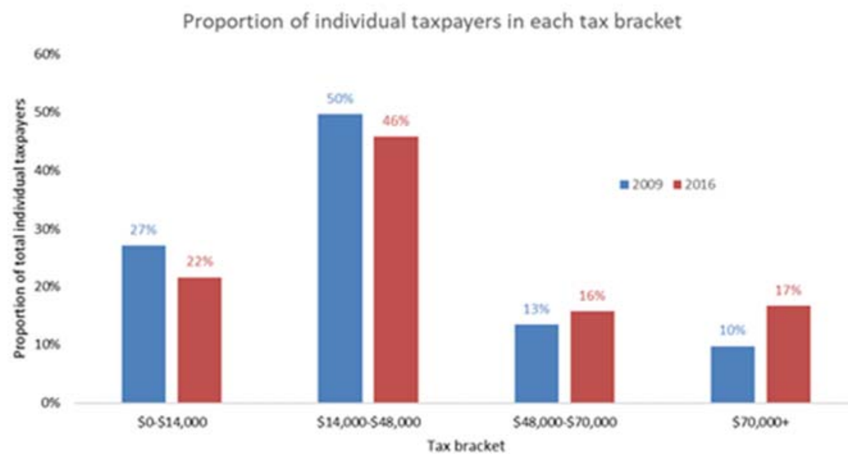
s9(2)(f)(iv)

Changes to other tax thresholds and/or rates

101. The Group has not focused on personal income tax settings at middle-to-upper income levels, but the Government could consider options here to support its objectives. Over time, more earners will move into higher tax brackets if personal income tax settings are not adjusted. Changes to middle and upper personal tax settings could support economic performance by affecting incentives to work, save, acquire skills and invest. More analysis would be required if you are interested in further advice on these options.

102. Figure 3 below illustrates how a greater percentage of taxpayers moved into the top two tax brackets since 2009.

Figure 3:



Welfare transfers

103. As the Group has noted, one option would be for a package to include a combination of tax and welfare transfer measures.

104. Both taxes and transfers are important for achieving distributional objectives. However, transfers can be targeted much more tightly to those with very low taxable incomes or particular needs (e.g., families with children).

105. Of the three Welfare Overhaul changes being considered for Budget 2019, two target sole parent beneficiaries, and include removing a sanction and allowing the passing-on

of child support. The third targets in-work beneficiaries, and proposes increasing abatement thresholds for main benefits.

106. There are a range of other measures that could be considered in the welfare space, including increasing the level of benefits and/or the accommodation supplement. To provide a sense of the size of significant welfare reform, s9(2)(f)(iv)
s9(2)(f)(iv)

107. The nature of any welfare component to a package should depend on the Government's specific objectives. The WEAG's final report may outline an approach to broader welfare reform and is expected to be sent to the Government in February.

Interaction between the tax and welfare systems

108. In designing a package, it would be necessary to consider how any personal income tax or welfare measures would interact with the current tax and transfer system. In particular, the effect that any change in tax thresholds would have on the abatement of some existing welfare measures would need to be managed to ensure that any changes did not result in unreasonably high effective marginal tax rates (EMTRs) for people receiving some benefits. This is something we can provide more detailed analysis on if you are interested in particular tax or welfare measures.

109. Comprehensive reform of the tax and welfare interface would be complex. In order to ensure that the interaction between the tax and welfare systems is fully taken into account, we would recommend that any decisions regarding personal tax and welfare measures be delayed until after Budget 2019. This would allow for the WEAG's conclusions to be fully taken into account before any measures are decided on, while also providing time to ensure that any measures that are implemented complement each other.

Business and Housing Measures

110. As noted earlier in this report, extending the taxation of capital gains would, on its own, be likely to have a negative impact on economic efficiency and productivity. The overall effects would depend on how the revenue is used. The Group has considered the following productivity-enhancing tax changes. In our view, these should all be part of a package if the tax reform is to support the efficiency and productivity objectives outlined in the Group's terms of reference:

a) restoring depreciation on buildings
b) expanding black hole expense deductibility, and
c) reducing restrictions on loss carry-forwards when a company is sold

111. In addition, removing residential rental loss ring fencing should contribute to the efficiency of extending the taxation of capital gains and reduce upwards pressure on rents. We comment on these measures below along with our high-level views on reducing the company tax rate as an alternative productivity-enhancing measure.

Restoring depreciation on buildings

s9(2)(f)(iv)

Note: Page 23 has been removed under section 9(2)(f)(iv) OIA

s9(2)(f)(iv)

118.

119.

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121.

122.

123.

Depreciation for seismic strengthening costs

124. s9(2)(f)(iv)

125.

126.

127.

Expanding black hole expense deductibility

128. Black hole expenditure is business expenditure that is expected to result in an economic cost to a taxpayer, but is neither immediately deductible for tax purposes, nor deductible over time.

129. The Group is considering a measure that would expand the situations when black hole expenditure would be deductible. This measure is estimated to cost around $120 million over five years.

130. s9(2)(f)(iv)

131.

Reducing restrictions on loss carry-forwards when a company is sold

132. Currently, tax rules restrict the carrying forward of any losses incurred by a company if the ownership of the company changes by more than 51%. This can create an impediment on small businesses that have made losses in the early years, but are looking to expand.

133. s9(2)(f)(iv)

134.

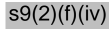
135.

Removing rental loss ring-fencing

136. One of the main rationales for removing rental loss ring-fencing was the lack of a comprehensive tax on capital gains made by landlords. This justification for loss ring-fencing would be removed if the gains on residential housing were taxed.

137. While there could still be some timing benefits, because gains would still only be taxed when realised, this is a general issue with taxing realised gains and there is no clear reason for special treatment of residential rental property over other capital assets. It is likely to lead to greater tax on debt-financed than equity-financed investment in rental property. Removing loss ring-fencing on rental property could also have potential benefits for improving housing supply and reducing pressure on rents, which would help to offset the potential upward pressure on rents from taxing capital gains.

138. This measure is estimated to cost around $1.3 billion over five years.



s9(2)(f)(iv)

KiwiSaver Measures

147. Extending the taxation of capital gains would result in savers, including those who save using KiwiSaver, facing a larger tax burden. Below we summarise three measures considered by the Group:

    a) decreasing lower KiwiSaver PIE rates
    b) removing tax on employer contributions to low-income KiwiSavers, and
    c) increasing the Member Tax Credit (MTC) for all KiwiSavers.

148. All of these measures would have an impact for low-income KiwiSavers by providing additional subsidies, but may not generate much additional saving (in addition to the

subsidies). In addition, they only support those low-income earners who are able to save. They are unlikely to have a significant impact on aggregate private saving. If the Government's objective is to support lower income households more generally, changes to the tax and welfare settings would likely be more effective than these KiwiSaver measures.

149. The KiwiSaver measures consider by the Group should also be viewed in light of the Treasury's recent advice on improving retirement outcomes by increasing enrolments in and contributions to KiwiSaver (T2018/3417 refers).

Decreasing lower KiwiSaver PIE rates

150. Currently, taxpayers in the top tax bracket of 33% only pay 28% in tax on income earned in their KiwiSaver PIE funds. In contrast, taxpayers earning less than $48,000 generally pay tax on income earned in their KiwiSaver PIEs at a rate that is the same as their marginal tax rate. This can be argued to be unfair as it reduces the progressivity of the tax system.

151. In its interim report, the Group recommended that all lower PIE tax rates be reduced for KiwiSaver funds to match the 5% saving that taxpayers in the top threshold already receive. This measure would provide targeted support for low-income savers.

152. This measure is estimated to cost around $630 million over five years.

Removing Tax on Employer Contributions to Low-Income KiwiSavers

153. The Group also made a recommendation in its interim report to remove the employer superannuation contribution tax (ESCT) for low-income individuals putting money into KiwiSaver. This measure would also provide some targeted support to low-income savers.

154. The measure would not apply to any individual who earns over $48,000. This effectively creates a "fiscal cliff" for taxpayers who earn close to that amount. The Group has since considered an alternative measure that would see the removal of ESCT abate at a rate of six cents for every dollar earned over $48,000. This removes the fiscal cliff problem, but does lead to a higher fiscal cost.

155. This measure is estimated to cost between $960 million and $1.7 billion over five years, depending on how the measure is designed to deal with the abatement issue.

156. We do not consider that this measure would be effective in increasing member contributions. It is an opaque way of providing a benefit to low-income savers (surveys showed that most KiwiSaver members were not aware of ESCT relief benefits when they applied earlier). It would also impose additional compliance costs on business and administration costs on Inland Revenue. Our initial view is that reducing lower KiwiSaver PIE rates would be a better measure.

Increasing the Member Tax Credit

157. The Group has considered increasing the Member Tax Credit (MTC) contribution that the Government makes to individuals investing via KiwiSaver schemes. The proposal being considered is to increase the contribution from $0.50 for every dollar invested (up to a cap of $1,042.86), to $0.75 for every dollar invested. This measure is estimated to cost around $2.5 billion over five years.

158. The proposal would not increase the amount that individuals would need to save in order to receive the full MTC. Instead, it would simply increase the total contribution that individuals would receive for investing $1,042.86 into KiwiSaver, from $521.43 to $782.15 (an increase of $260.72 per year).

159. We consider that increasing the MTC would not have a significant impact on encouraging new savings (beyond the direct increase resulting from the Government's injection). While increasing the rate of the MTC to $0.75 may incentivise some individuals to enter into KiwiSaver who are not currently saving, this number is likely to be small. The current MTC of $0.50 for every dollar invested is already a significant return compared to other savings options. Most of the benefit of this measure would go to savers who are already contributing at least $1,042.86.

160. The Group is also considering a measure that would give the full MTC to primary caregivers in the first year that their child is born. This would ensure that the KiwiSaver savings of primary caregivers continues to increase while they are not in paid work. This would reduce the negative impact that taking time off work to care for a new child can have on an individual's lifetime savings. This measure is estimated to cost around $60 million over five years.

Summary of Officials' Views

161. Officials would support extending the taxation of capital gains if implemented as a package with other complementary measures. We consider that a broad extension of the taxation of capital gains (excluding the family home) would likely meet a number of the objectives in the Group's terms of reference, particularly the objectives to improve the fairness, sustainability and integrity of the tax system. It would also reduce the extent to which tax settings bias investment decisions, and thereby likely lead to a more efficient allocation of capital in the economy.

162. In order to address the efficiency and productivity objectives outlined in the Group's terms of reference, extending the taxation of capital gains would need to be part of a package including measures to support business investment and productivity.

163. Of the measures considered by the Group, we would recommend those outlined in the table below. These measures would all address significant inefficiencies in the structure of the tax system that are currently acting (or would act) to bias decisions.

164. We would recommend measures 2 to 4 whether or not the Government was considering extending the taxation of capital gains (subject to revenue constraints). However, they would also be an important business offset for extending the taxation of capital gains. In respect of measure 5, the case for residential loss ring-fencing, in particular, is much reduced if capital gains are taxed more broadly.

Policy measure	Rationale	Indicative 5-year revenue impact (from 2021/22)
1. Extending income tax to include realised capital gains (excluding the family home)	Increase fairness, sustainability and integrity of the tax system	+$10 billion
2. Allow businesses to claim depreciation expenses on buildings	Encourage more business investment and improve efficiency of investment	s9(2)(f)(iv)
3. Allow businesses to deduct expenses for "black hole" expenditure	Encourage innovation and entrepreneurship	-$0.12 billion
4. Allow businesses to keep losses when the owner changes	Make it easier for small companies to expand	-$0.24 billion
5. Remove residential rental loss ring-fencing	Recognising that gains would be taxed, this would reduce upward pressure on rents and increase efficiency	-$1.3 billion (preliminary estimate, likely to be lower)

Note: These fiscal estimates are highly uncertain, preliminary, indicative, and are subject to further refinement. Projected revenue from extending the taxation of capital gains is likely to be revised downward because of new data that has become available in the last week. The revenue would build up slowly over time and be volatile.

165. We consider that a package with these core elements would be cohesive and effective in contributing to the Government's overall objectives for the tax system. This package would:

- make the tax system significantly more progressive
- increase fairness through a more consistent taxation of capital income (horizontal equity)
- improve revenue integrity and sustainability
- increase incentives to develop land for productive purposes, and
- improve business tax to better support investment, innovation and productive risk-taking.

166. The above core package would leave room for remaining revenue to be used for other priorities. We would expect the above revenue-negative measures to have a revenue cost of around a third to a half of the revenue raised from extending the taxation of capital gains over the first five years. Depending on the Government's overall priorities, the remaining revenue could be used for other revenue-negative tax measures, expenditure initiatives, reducing debt, or setting aside for future Budget decisions.

167. The Government could announce personal tax or some welfare measures at Budget 2019. However, officials would recommend delaying design decisions on personal tax and welfare settings until after Budget 2019. Deferring decisions would enable time to take account of the WEAG's recommendations and provide the necessary time to develop an integrated personal tax and welfare reform package.

Next Steps

Timeline for Legislation

168. A number of submissions on the Group's interim report noted concern with the publicly available timeframes indicated for the generic tax policy process (GTPP) and legislative process beyond its final report. The Group requested officials' advice on this process.

169. Our advice was that, if Cabinet decides it wants to enact legislation before the 2020 General Election to extend the taxation of capital gains, legislation would need to be introduced by November 2019. Before this, there would need to be a consultation on detailed design decisions, which would need to start around May 2019 with the release of a Government discussion document.

170. We noted that this timeline does not leave much time for detailed design decisions to be made. As noted throughout this report, there are a number of complex design decisions that will need to be made before legislation can be introduced. This report has only touched on the high-level design decisions. There are many other complex issues associated with extending the taxation of capital gains that we have yet to discuss with you.

171. There is a risk that rushing consultation undermines the GTPP. Under GTPP, changes to tax policy are supposed to go through a process of consultation with the general public, including the private sector. One of the main goals of GTPP is to ensure that all policy issues that have a significant impact on the public are considered by officials before legislation is drafted. Consultation on the policy issues before legislation is introduced allows consultation after legislation is introduced to focus on how well the legislation actually implements the Government's policy decisions, rather than on issues with the policy itself.

172. More time being built into this process would ensure that, through adequate consultation, legislation is fit for purpose, well-understood, well-tested to ensure that it achieves the Government's objectives, and workable. This would minimise the need for further legislative change in the future.

173. Legislation that requires substantial amendment post-enactment increases uncertainty and can impose significant compliance costs on taxpayers, who may have to update their processes in response to changes in the way that the tax operates.

174. We have advised the Group that we consider including all legislation in one Bill is preferable to splitting it over multiple Bills, as this provides a better opportunity to achieve a coherent and sustainable change to the tax system. It would also eliminate the need for temporary measures that may be necessary to enforce boundaries that would exist in the short term but not once all relevant asset classes were subject to tax.

175. In saying this, officials can meet the proposed timeline. However, because of the risks involved, our recommendation is that the timeline be amended to allow legislation to be introduced in the middle of 2020 with an effective date of 1 April 2022.

176. Finally, extending the taxation of capital gains would require considerable IT changes within Inland Revenue, and preparation to assist taxpayers with implementation and ongoing compliance (for example, information, education and relevant forms). This means, particularly if the effective date of 1 April 2021 is retained, Inland Revenue will need to incur significant implementation costs through 2019-21.

Process for further advice

177. The Group is expected to send you its final report in late January 2019. Officials will provide you with a report at the same time setting out where we agree and disagree with the Group's final recommendations.

178. In order for the Government's response to the final report to be included in Budget 2019, you will need to make final policy decisions in March, and take papers to Cabinet in April.

179. To help facilitate the making of these decisions, we propose sending you a series of reports seeking your provisional decisions on both the design choices for extending the taxation of capital gains, and on how the revenue raised could be allocated. These reports would be sent to you throughout late January and February. The topics covered in these detailed reports can be based on your feedback on this report.

180. We suggest no final decisions be made until March, once you have had the opportunity to consider these additional reports.

181. After final decisions are made, we propose preparing a paper for Cabinet to consider, as well as a discussion document on extending the taxation of capital gains that could be released at Budget 2019.

182. We also propose preparing material for a series of workshops with your Ministerial colleagues on the Group's final report. These workshops would be of a similar nature to the workshops carried out prior to the Group's interim report going to Cabinet. Subject to your approval, officials can liaise further with your offices on the timing and content of these workshops.