Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Inclusion of asset groups in a capital gains tax

Date:	14 December 2018	**Priority:**	Medium
Security level:	Sensitive - Budget	**Report number:**	IR2018/803 T2018/3721

Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	None
Minister of Revenue	**Note** the contents of this report	None

Contact for telephone discussion (if required)

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14 December 2018

Minister of Finance
Minister of Revenue

Analysis

1. This report responds to your request for information on the following:

    - pros and cons of staggering application to different assets,
    - pros and cons of excluding business assets from the base; and
    - pros and cons of excluding baches from the base.

2. The report has been pulled together quickly and we have not had time to consider the issues in depth. We can provide a more considered and detailed response if required.

Staggering application

3. The Tax Working Group (the Group) have looked at a capital gains tax that applies to the following asset classes:

    - Land and buildings (including holiday homes)
    - Shares
    - Intangible property held for business or investment purposes
    - Business and investment assets

4. The following assets are excluded from the Group's proposal:

    - Family home and the land under it
    - Personal use assets (e.g. cars, boats, jewellery, art)

5. We understand that the indicative timetable the Government is working to is:

    - Tax Working Group report released by the Government in February 2019;
    - A discussion document released on Budget day 2019;
    - A bill introduced in Parliament in October or November 2019;
    - Bill enacted before the next election (expected to be in late 2020); and
    - New law to take effect from 1 April 2021.

6. Officials consider this timetable is challenging but achievable. However, there will be risks of insufficient consultation and drafting errors in the legislation due to the short timeframe for policy development and drafting. There is also a concern that rushed legislation may lead to ongoing legislative change and this could add to compliance costs. It may be especially difficult for managed funds to meet the timetable as they have advised it would require significant systems changes.

7. One option to reduce this risk is to delay the entire process and aim for a start date of 1 April 2022.

8. You have asked if it is possible that some aspects of the regime come into effect before other aspects. Officials' recommendation is that the regime come into effect at the same time for all asset categories, either on 1 April 2021, or 1 April 2022. We see the following as the key pros and cons of staggered application:

9. Pros of staggering application are:

- The easiest aspects of the regime could be enacted quickly and start raising revenue. An example could be residential investment property, as it is already subject to the five-year bright-line test (although some aspects of this may need to be changed, such as the approach of exemptions and rollovers and family home issues);
- Some of the more difficult aspects of the regime could be given more time for consultation and development. These include application of business assets to rollovers, the treatment of corporate groups, and application of the regime to managed funds.

10. Cons of staggering include:

- The benefits of taxing capital gains more comprehensively will be delayed, including revenues, horizontal equity and vertical equity benefits. Forecast estimates show that after five years including land used for business purposes in the base would raise up to 50% more revenue compared to taxing only personal investment assets;
- Temporary boundary issues and related rules that would not be needed once the regime applied more widely. For example, if there is an intention that the regime apply first to residential investment property but not to shares in closely-held companies, then that intention could be defeated if the property is held in a company which could be sold by selling the shares. While there is a bright-line anti-avoidance rule that can easily be adapted to make a sale of any residential property-owning company taxable, those rules would no longer be necessary when the sale of shares in controlled companies became taxable;
- Public perceptions of fairness could be undermined if the regime applies first to fairly commonly-owned assets, such as residential investment property; but not assets such as shares in controlled companies, which may be owned by wealthier owners.;
- A risk that the full regime is never implemented, due to changing Government priorities and reducing marginal gains from incremental extensions.

11. Overall, officials consider the advantages of staggering are outweighed by its disadvantages. In particular, we consider the complexity and integrity costs that would be associated with the boundary issues created by staggering would be likely greater than the benefits of having more time to develop the phased aspects of the regime.

Application to different types of assets

Investment assets

12. Investment assets include residential investment property and could include other forms of real property held for passive rental. For the purposes of the revenue estimates we assume all commercial, rural, and industrial land is treated as business assets even if owned for rental.

Business assets

13. Business assets include the assets of an active business, such as real property used in farming or industry, business goodwill, shares of subsidiaries in a corporate group, and shares of a controlled company.

14. Pros of excluding business assets from the tax base include:

- Simplicity, especially from the exclusion of subsidiaries in a corporate group and less pressure for rollovers. The complexity from subsidiaries arises from trying to ensure there is as little double tax or double deductions as possible.
- No need to value goodwill on valuation date

15. Cons of excluding business assets from the tax base include:

- Less revenue;
- Reduced integrity protection if the sale of shares in a controlled company is not taxed, as that helps reduce the effectiveness of schemes to avoid dividend taxation;
- The regime would be less progressive because gains on the sale of controlled companies can be a source of very large gains

16. There are possible intermediate options. For example, it is possible to exclude active business assets generally but still tax the gain on the sale of controlled companies for the benefits of integrity and progressivity (although that would mostly remove the advantage of not needing to value goodwill).

Baches (second homes)

17. By baches we are referring to residential property that is not the owner's excluded family home, and is not residential investment property, but is occupied by the owner and family temporarily as a second home or holiday home.

18. Pros of excluding baches from the tax base include:

- The Working Group has proposed that gains on baches should be taxable but losses should not be deductible. This has some merit under tax policy principles as losses on assets which generate consumption benefits are not deductible. For example, a business owner can only claim deductions for expenses incurred in producing income and not for consumption expenses. It may, however be a communications challenge for the Government to explain why they are taxing the gains but not allowing a deduction for losses;

- Reduces compliance and record-keeping costs for bach owners.

19. Cons of excluding baches from the tax base include:

- Reduced revenue (estimated $200 million in the first five years);

- Progressivity;

- Baches are currently taxable under the five-year brightline, so exempting them could be a reduction from the current tax base (unless the brightline is retained just for baches).

- Taxing the gain on residential investment property but not baches creates a perverse incentive for the owner to keep the bach vacant when they are not using it, rather than make it available for others to tenant;

- Baches are often rented temporarily when the owner is not using them. If we tax the gain on residential investment property but not baches, then it would create boundary and apportionment issues of whether the gain is taxable, or how much of the gain should be taxable.

- Taxing residential investment property but not baches may require integrity rules to ensure that owners of baches that have gone down in value cannot retrospectively classify them as residential investment properties to get a tax loss.

Financial implications

20. The following tables show forecast revenues from applying the regime just to investment assets (including rental property, baches and shares), and then to business assets. It shows that gains on business assets (assumed to be land used for business purposes) would raise more than 50% more revenue compared to taxing only gains from personal investment assets. This includes forecasting the estimated impact of the small business rollover proposed by the Working Group. We consider the revenue gains from taxing business assets are likely to be understated as there is no data on gains in intangible business assets such as goodwill or capital gains generated through the labour efforts of the owners of businesses, e.g., through renovating properties or building up client lists.

21. If some assets are excluded from being taxed at the company level, but gains are taxed at the shareholder level, then there will likely be some significant recapture of gains which would reduce the fiscal cost of excluding assets from taxation at the company level.

The offset would be reduced to the extent that:

- the payment of tax is deferred until shares are sold
- companies are owned by non-residents (non-residents would not be taxed on share gains).

We have not had time to cost this offset.

Table 1: Projected revenue from taxing more capital gains on investment assets ($ billion)

Year	2021/22	2022/23	2023/24	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Residential investment	0.18	0.45	0.71	0.96	1.2	1.4	1.7	1.9	2.1	2.4
Baches	0.01	0.03	0.04	0.05	0.07	0.08	0.09	0.11	0.12	0.13
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	0.45	0.98	1.45	1.87	2.27	2.61	3.03	3.36	3.71	4.07
% of GDP	0.13%	0.27%	0.38%	0.47%	0.55%	0.61%	0.66%	0.71%	0.75%	0.79%
% of total tax revenue	0.44%	0.90%	1.28%	1.59%	1.85%	2.06%	2.24%	2.41%	2.55%	2.68%

Table 2: Projected revenue from taxing more capital gains on business assets ($ billion)

Year	2021/22	2022/23	2023/24	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31	2031/32
Commercial, industrial and other property	0.09	0.22	0.36	0.49	0.63	0.77	0.9	1	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
Total	0.16	0.39	0.63	0.86	1.09	1.32	1.54	1.73	2.01	2.19
% of GDP	0.04%	0.11%	0.16%	0.22%	0.26%	0.30%	0.34%	0.37%	0.40%	0.43%
% of total tax revenue	0.15%	0.36%	0.56%	0.73%	0.88%	1.02%	1.15%	1.27%	1.37%	1.47%

22. The estimates are preliminary and uncertain and subject to change. In particular, officials are reviewing the accuracy of the turnover assumption used in costing and this could result in a reduction of revenues forecast in the real property categories.

Next steps

23. Officials will discuss this with you at your meeting on Monday 17 December.

Recommended action

We recommend that you **note** the contents of this report.

Noted

Noted

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