POLICY AND STRATEGY

Tax policy report: **Extending the taxation of capital gains: response to Ministers' requests on business impacts**

Date:	11 January 2019	**Priority:**	Medium
Security level:	Sensitive	**Report number:**	IR2019/015 T2019/18

Action sought

	Action sought	**Deadline**
Minister of Finance	**Note** the contents of this report **Discuss** with officials	15 January 2019
Minister of Revenue	**Note** the contents of this report **Discuss** with officials	15 January 2019

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**
Emma Grigg	Policy Director, Inland Revenue	s9(2)(a)
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Mark Vink	Manager, the Treasury	

11 January 2019

Minister of Finance
Minister of Revenue

Extending the taxation of capital gains on business: response to Ministers' requests on business impacts

Executive summary

1. At our meeting on 17 December 2018, you requested information on the following:

   - Tax-free thresholds or exemptions for small business owners from a capital gains tax (e.g., a lifetime threshold exemption or retirement exemption);
   - s9(2)(f)(iv)
   - Options to reduce valuation costs for businesses if a Valuation Day approach is adopted in extending the taxation of capital gains.

Tax-free thresholds or exemptions for small business owners

2. Tax-free thresholds and exemptions are used by some countries such as Australia, Canada and South Africa to provide concessional tax treatment of capital gains for small business owners. In Australia and South Africa, these provisions are linked to retirement, while in Canada they are 'lifetime exemptions'. Other countries, such as the UK and US, do not have retirement or lifetime exemptions for small business owners.

3. The Tax Working Group is likely to recommend a one-off retirement concession where the first $500,000 of capital gains derived from a closely-held active business may be taxed at reduced KiwiSaver PIE tax rates rather than personal tax rates. This is less concessionary than other countries, particularly Australia, as the capital gains are still subject to tax (albeit at a lower rate) rather than exempt. However, the tax treatment of retirement savings is generally more concessionary in Australia than New Zealand. Therefore, the Australian exemptions should be less distortionary than they would be in a New Zealand context.

4. We consider that while there may be some benefits in providing a concession for small business owners, these are outweighed by a number of other considerations including equity, efficiency, integrity and fiscal matters. If the Government wishes to reduce the impact on small businesses of extending the taxation of capital gains, we would suggest considering other measures including compliance cost savings measures proposed by the Group (e.g., lifting the threshold for automatically deductible legal expenditure from $10,000 to $20,000), or other business tax measures such as lifting the threshold for low value asset write-offs (currently $500).

s9(2)(f)(iv)

6.

Valuation costs for businesses

7. Like Ministers, the Tax Working Group has been cognisant of striking a balance between accurate valuations and reasonable compliance costs for taxpayers in valuing their assets. Officials are considering a range of valuation methods taxpayers could use to value their businesses to help reduce compliance costs. Some business owners may wish to get their businesses professionally valued. However, alternative low cost options could be made available, such as (a) straight-line valuation; (b) using the values from existing accounting standards; and (c) valuation proxies that have been adopted by other countries transitioning into the taxation of capital gains.

Updated revenue estimate

8. Officials have revised down the projected revenue from taxing capital gains more comprehensively. Officials previously provided an estimate that taxing capital gains would raise approximately $10 billion over the first five years following introduction (T2018/3348, IR2018/763 refers). The estimated revenue is now $8.3 billion over the five years.

9. The revised estimate is a result of additional information received by officials and refinement of the modelling approach. The estimate is still higher than the revenue estimate provided in the Tax Working Group's interim report ($7.7 billion over the first five years).

Next steps

10. We propose to discuss the contents of this report with you at our meeting of Tuesday 15 January 2019.

11. We are preparing a comprehensive briefing report for 29 January 2019 covering all the Tax Working Group's recommendations in their final report.

Recommended action

We recommend that you:

12. **Note** the contents of this report.

    Noted Noted

13. **Agree** to discuss the contents of this report with officials on Tuesday 15 January 2019.

    Agreed/Not agreed Agreed/Not agreed

Mark Vink
Manager
The Treasury

Emma Grigg
Policy Director
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Background

14. The Tax Working Group (hereafter referred to as the Group) will provide its final report to the Government in late January 2019. To help prepare you for the decision-making process that will follow the final report, we provided you with our joint report of 14 December 2018 (T2018/3429, IR 2018/800 refers) outlining our initial advice on potential tax reforms.

15. At the meeting on 17 December 2018 to discuss the joint report of 14 December 2018, you requested information on the following:

    - Tax-free thresholds or exemptions for small business owners from a capital gains tax (e.g., a lifetime threshold exemption or retirement exemption), similar to what has been adopted in some countries such as Australia and Canada.
    - s9(2)(f)(iv)
    - Options to reduce valuation costs for businesses if a Valuation Day approach is adopted in extending the taxation of capital gains.

16. We have prepared this report to address these points. We also provide an update on the revised estimate of the revenue from extending the taxation of capital gains.

Tax-free threshold for small business owners

17. Some countries with comprehensive capital gains tax regimes have tax-free thresholds through either (a) lifetime exemptions; or (b) retirement exemptions.

18. We summarise how these thresholds/exemptions generally work and the extent to which they have been adopted by five other countries (Australia, the United Kingdom, the United States, Canada and South Africa) below. We then outline a similar concession that we expect to be proposed by the Group and some factors to consider in whether to adopt such an exemption or concession.

Lifetime and retirement exemptions

19. Under a lifetime exemption, small business owners are not taxed on any capital gains until their gains exceed the level of the threshold for the exemption (accumulated across the taxpayer's life).

20. Under a retirement exemption, small business owners are not taxed on any capital gains realised for retirement. There is generally a minimum age at which the retirement exemption can apply plus other conditions such as the period of time over which the owner must have owned the business.

21. The retirement exemption can be combined with a lifetime exemption such that the gains are not taxed if they are under the threshold.

22. Table 1 summarises our understanding of the lifetime and retirement exemptions in five other countries that have generally been referred to in the Secretariat reports to the Group. Further detail on the exemptions are provided in Appendices [A] to [C] for Australia, Canada and South Africa.

Table 1: Lifetime and retirement exemptions in other countries

Country	Exemption (Yes/No)	Summary
Australia	Yes	Retirement exemption of A$500k (NZ$530k) for gains from small business active assets. If the small business owner is under 55, the exempt gain must be paid into a complying superannuation fund or retirement savings account to qualify. Australia also has a separate retirement exemption for sales of active assets that have been owned by a small business for at least 15 years, provided the owner is at least 55 or is permanently incapacitated.
UK	No	
US	No	
Canada	Yes	Lifetime exemption of C$848k (NZ$950k) for gains from small business corporation shares. C$1m (NZ$1.1m) for gains from farm and fishing property. The exemptions are not cumulative so an individual can never be exempt on more than C$1m of capital gains. Canada applies half-inclusion to capital gains so a C$1m exemption would exempt $500k of taxable gains.
South Africa	Yes	Retirement exemption of R1.8m (NZ$200k) for gains from small business active assets (or shares in small businesses to the extent the business has active assets) for retirement (the small business owner must be at least 55).

Group recommendation

23. We understand the Group is likely to recommend a one-off retirement concession for taxpayers that have owned a closely-held active business for a certain period of time (e.g., 15 years) and sell that business once they reach a certain age (e.g., 60). Rather than exempt the capital gain, we understand the concession is that the first $500,000 of any capital gain from the sale will be taxed at reduced KiwiSaver PIE tax rates (i.e., 5.5%, 12.5% and 28%) that are being proposed by the Group.

24. While this is less concessionary that the Australian retirement exemptions in Table 1, the tax treatment of retirement savings is generally more concessionary in Australia than in New Zealand. Therefore, the Australian retirement exemptions are likely to be less distortionary than they would be in New Zealand, as the exemptions can help ensure that taxpayers who save for their retirement through their small business are not disadvantaged compared to other taxpayers who save for their retirement through tax preferred superannuation funds.[1]

Factors to consider in deciding whether to adopt a lifetime or retirement exemption or concession

25. There are a number of factors to consider in deciding whether to adopt a lifetime or retirement exemption or concession. The primary benefit is that it reduces the tax on small business owners and helps preserve the savings of those who fund their

[1] For example, concessional contributions into a complying superannuation fund are taxed at 15% in the fund; complying superannuation funds' earnings are taxed at 15%; complying superannuation funds' income from assets held to support retirement phase income streams is exempt; and concessional tax rates and tax offsets apply to lump sum and income stream payments from complying superannuation funds.

retirement by selling their small businesses. Lifetime or retirement exemptions, depending on their design, could also remove many small business owners from the taxation of capital gains, reducing their compliance costs.

26. However, this needs to be weighed against a number of other considerations including:

- *Reduced fairness.* Providing a lifetime exemption for saving through a small business but not for other types of savings such as in managed funds, listed shares, rental property or term deposits may be perceived to be unfair. Whether a retirement concession increases or reduces fairness will depend on how consistently it treats small business owners relative to other taxpayers.
- *Reduced efficiency.* Small business tax exemptions may incentivise some undesirable behaviour. For example, some businesses may be dis-incentivised from growing beyond a certain point if larger businesses do not qualify for the exemption, or the business owners may be incentivised to sell a business before it becomes so large that it ceases to qualify for the exemption.
- *Increased complexity and reduced integrity.* Complexity is increased by additional rules required to determine which businesses and assets are eligible for the concession. Moreover, the experience in Australia and Canada is that some high-wealth taxpayers have been able to structure their arrangements to qualify for small business exemptions. All the Australian practitioners we spoke to expressed concern with Australia's small business concessions due to the complexity and integrity issues.
- *Increased compliance costs.* Because of the increased complexity, compliance costs may not be reduced as small business owners may still need to calculate their capital gains and keep track of the use of the lifetime limit over time. If the objective is to reduce compliance costs it is usually better to make the general tax rules as simple as possible, rather than enacting a special concession for small businesses.
- *Reduced revenue.* Exemptions would reduce the revenue collected from the tax. While a small business exemption may seem relatively minor, it may become harder to justify not providing other exemptions or concessions if there is a small business exemption. Both increased compliance costs and reduced revenue can increase the ratio of compliance costs to revenue raised.

27. The relative importance of the factors noted above will depend on the design of the exemption. We can provide further information on lifetime threshold and retirement exemptions if helpful.

28. Overall, we consider that while there may be some benefits in providing an exemption for small business owners, these are likely to be outweighed by other considerations including equity, efficiency and integrity concerns. If the Government wishes to reduce the impact on small businesses of extending the taxation of capital gains, we would suggest considering other measures including compliance cost savings measures proposed by the Group (e.g., lifting the threshold for deductible legal expenditure from $10,000 to $20,000), or other business tax measures such as lifting the threshold for low value asset write-offs (currently $500).

s9(2)(f)(iv)

Note: Pages 7 to 8 have been removed under section 9(2)(f)(iv) OIA

47. s9(2)(f)(iv)

48.

Valuation costs for businesses

49. You have asked for options to reduce valuation costs for businesses if a Valuation Day approach is adopted in extending the taxation of capital gains. This concern is shared with the Group. Officials' work is ongoing on this matter but we provide a summary of the high level thinking to date below.

50. In brief, we are considering a range of valuation methods taxpayers could use to value their businesses. Some business owners may wish to get their business professionally valued. However, alternative low cost options could be made available, such as:

- *Straight-line valuation* – the value of an asset on Valuation Day is determined by pro-rating the asset's change in value over the time it has been held. This method requires very little information and an online calculator could also be made available to assist taxpayers;[2]

- *Existing reporting standards* – International Financial Reporting Standards (IFRS) require business assets to be valued at a fair market value. If a business uses IFRS, the value on Valuation Day could be the value adopted under those standards; and/or

- *Valuation proxies* – we are exploring whether certain proxies could be used to help determine the value of a business, such as discounted sale price, turnover, type of business, and business assets that can be easily valued.[3]

51. While a professional valuation is likely to be the most accurate method of valuing a business, it may come at a greater cost to the taxpayer. Other methods by contrast may represent a lower cost to the taxpayer but may less accurately represent the associated capital gain or loss incurred.

52. The advantage in allowing taxpayers to select the most suitable method to value their particular business is that it would allow taxpayers to weigh-up trade-offs such as cost, accuracy and simplicity.

[2] South Africa used straight-line valuation as their default valuation method when they introduced their capital gains tax.

[3] South Africa allows business owners to treat 20% of the proceeds of sale to be treated as the value of the asset as Valuation Day and the capital gains tax is then calculated on the remaining 80%.

53. We will report to you on this matter again as the broader workstream of extending the taxation of capital gains develops.

Updated revenue estimate

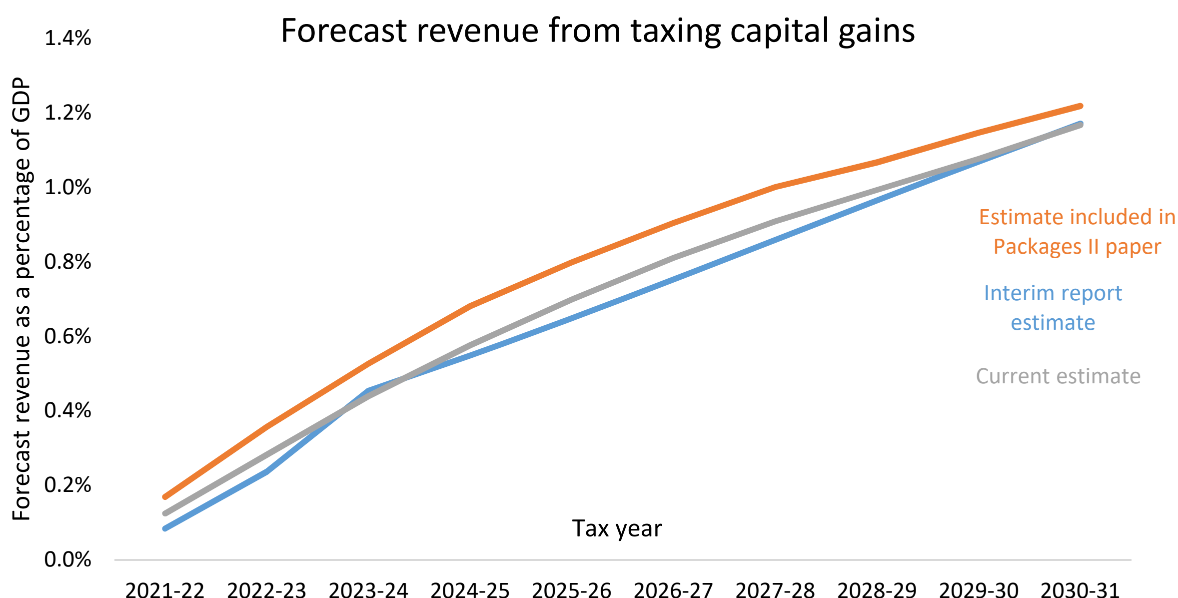
54. Officials have revised down the projected revenue from taxing capital gains more comprehensively. Officials previously provided an estimate that taxing capital gains would raise approximately $10 billion over the first five years following introduction (T2018/3348, IR2018/763 refers). The estimated revenue is now $8.3 billion over the five years. We briefed the Group on these revisions on 19 December 2018.

55. This revised estimate is a result of additional information received by officials and refinement of the modelling approach. In particular the reasons for the changed revenue estimate are:

- Better data:
    - The Secretariat has obtained better data regarding average holding periods for land in New Zealand. The previous holding period data being used by the Secretariat had some low quality data that reduced the average holding period.
    - The Secretariat has updated the behavioural assumptions for the "lock-in effect" (how much longer people will likely hold property for as a result of taxing capital gains). This assumption is now based off the difference in holding periods between Australia and New Zealand.
- Refinement of modelling:
    - Rental loss ring-fencing is now built into the projection so that ring-fenced losses are assumed to be able to be offset against capital gains for residential property on sale.
    - Second homes are now included in the revenue projection

56. The revised estimate will be included in the Tax Working Group's final report. The estimate is still higher than the revenue estimate provided in the Group's interim report ($7.7 billion over the first five years).

57. The better data and modelling refinement have resulted in related changes to the fiscal estimate of some of the revenue-negative measures (e.g., depreciation on buildings) as well. This is set out in the following graph.



Next steps

58. Officials propose to discuss the contents of this report with you on Tuesday 15 January 2019.

59. We will report to Ministers again on 29 January 2019 when we provide the Tax Working Group's final report.

APPENDIX A: AUSTRALIAN EXEMPTIONS

Australia has two capital gains tax ("CGT") lifetime threshold/retirement exemptions for small businesses:[4]

- **Retirement exemption for 15 year assets**. A capital gain from the sale of an active asset that has been continuously owned by a small business for at least 15 years is exempt, provided the business owner is aged 55 or over and is retiring or is permanently incapacitated.
- **Retirement exemption up to AU$500,000 lifetime limit.** Capital gains from the sale of small business active assets are exempt up to a lifetime limit of AU$500,000 (approximately NZ$530,000). If the small business owner is under 55, the exempt amount must be paid into a complying superannuation fund or a retirement savings account to qualify.

The tax treatment of retirement savings is generally more concessionary in Australia than in New Zealand, so Australia's exemptions are less distortionary in that context.

Basic conditions of the concessions

The concessions are only available to "small businesses" that sell "active assets":

- **Small businesses**. The business must have less than AU$2m (approximately NZ$2.1m) of annual turnover and less than AU$6m (approximately NZ$6.3m) of net CGT assets. In applying these thresholds, the turnover and assets of commonly-controlled businesses (40% or more common ownership) and affiliates (another business that the person does not control but is expected to act in accordance with their directions or wishes) are added together.
- **Active assets.** A CGT asset will be an active asset if it was owned or used in the course of carrying on a business, or if it is an intangible asset (for example, goodwill) inherently connected with the business. To qualify, an asset must have been an active asset for at least 7.5 years (if owned for more than 15 years), or half the period of ownership (if owned for fewer than 15 years). Shares in another closely-held company can qualify if the other company has 80% active assets. Depreciable property and trading stock do not qualify as they are not CGT assets.

[4] See http://www.ato.gov.au/General/Capital-gains-tax/Small-business-CGT-concessions/.

APPENDIX B: CANADIAN EXEMPTIONS

Canada has two small business lifetime threshold exemptions:

- **Lifetime exemption for small business corporation shares**.[5] A lifetime exemption for gains of up to C$848,252 in 2018 (approximately NZ$950,000) is available to individuals selling shares in a "qualified small business corporation". The exemption is indexed to inflation. At least 90% of the market value of the corporation's assets must be "active assets", which are used mainly in an active business primarily in Canada. Examples of assets that may not qualify include rental property, stocks, and bonds (unless the stocks or bonds are in a connected corporation that is a small business corporation). In addition, during the 24 months before the sale of the small business corporation's shares, the individual (or certain associates) must have owned those shares, and more than 50% of the market value of the corporation's assets must have been used principally in an active business carried on primarily in Canada.

- **Increased lifetime exemption for qualified farm and fishing property.[6]** The lifetime exemption for qualified farm and fishing property is effectively increased to C$1m (approximately NZ$1.1m), with similar conditions as the exemption for small business corporation shares. The exemptions are not cumulative so the "additional exemption" for qualified farm and fishing property in 2018 is C$151,748 (being C$1m less C$848,252). The C$1m amount is not indexed to inflation so, once the indexed exemption for small business corporations exceeds C$1m, that limit will also apply to qualified farm and fishing property (i.e. there will be no additional exemption).

It should be noted that Canada applies half-inclusion to capital gains so a C$1m exemption would exempt C$500,000 of taxable gains.

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[5] Canada Revenue Agency *Capital Gains 2017* (T4037) at https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4037.html.

[6] https://www.canada.ca/en/revenue-agency/programs/about-canada-revenue-agency-cra/federal-government-budgets/budget-2015-strong-leadership/lifetime-capital-gains-exemption-qualified-farm-fishing-property.html

APPENDIX C: SOUTH AFRICAN EXEMPTION[7]

South Africa provides a lifetime threshold/retirement exemption of R1.8m (approximately NZ$200k) of capital gains from the sale of small business assets for retirement.

The conditions of the exemption are:

- **Small business**. This is defined as a business that has gross assets with a total market value less than R10m (approximately NZ$1.1m) at the time of sale. Liabilities are ignored in applying the threshold.

- **Active business assets**. These can be either:
    - immovable property (i.e. land) to the extent it is used for business purposes; or
    - other (movable) property used or held wholly and exclusively for business purposes.

  'Passive' assets such as financial instruments (e.g. shares, debt) and assets held in the course of carrying on a business mainly to derive annuity income, rental income, foreign exchange gains, royalties, or similar income are excluded. However, the sale of an entire direct interest in a company of at least 10% may qualify, to the extent that the interest relates to the active business assets of the company. Apportionment is required if the company holds both active and passive assets.

- **5 years of ownership**. The asset must have been held for at least 5 years continuously before the sale.

- **Substantial involvement**. The natural person must have been substantially involved in the operations of the small business during that period.

- **Retirement age.** The individual selling the asset must be at least 55 years old, or else the sale must have been due to ill-health, superannuation or death.

- **Disposals within 24 months**. Capital gains can only qualify for the exemption if they are realised within 24 months of the first qualifying disposal by the individual.

[7] http://www.sars.gov.za/TaxTypes/CGT/Exclusions/Pages/Disposal-of-small-business-assets.aspx