POLICY AND STRATEGY

Tax policy report: Major Design Issues in the Taxation of Capital Gains

Date:	8 February 2019	**Priority:**	High
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Action sought

	Action sought	**Deadline**
Minister of Finance	**Note and discuss** the contents of this report	12 February 2019
Minister of Revenue	**Note and discuss** the contents of this report	12 February 2019

Contact for telephone discussion (if required)

Name	**Position**	**Telephone**	
Mark Vink	Manager, the Treasury	s9(2)(a)	
Paul Kilford	Policy Manager, Inland Revenue		

8 February 2019

Minister of Finance
Minister of Revenue

Major Design Issues in the Taxation of Capital Gains

1. This Report provides information and seeks direction from Ministers on a number of the main issues involved in designing an extension of capital gains taxation.

2. It is intended to allow Ministers to provide guidance to officials as they develop material for an eventual discussion document. Ministers are also invited to indicate areas where they need further information.

3. This report is the first of two on capital gains design. It includes questions on high-level design principles that officials would like to discuss with Ministers at the Joint Ministers' meeting scheduled for 12 February. Although it does not seek final decisions, the answers to these questions will be helpful for the drafting of the subsequent report on the detailed design recommendations of the TWG report, scheduled to be delivered to Ministers on or around 22 February.

Part A: Majority and the Minority Recommendations

4. The majority of the Group has recommended a broad extension of capital gains taxation. A minority has recommended that capital gains taxation be extended only to residential property other than the family home. The minority recommendation was further split between extension to residential rental property only or residential rental property plus second homes.

5. This part compares the majority and minority recommendations with respect to the Government's objectives.

6. As noted in previous reports, the majority recommendation affects the Government's objectives as stated in the terms of reference for the Tax Working Group. It would significantly increase progressivity and horizontal equity. It would improve the integrity and sustainability of the tax system. It would have mixed effects on efficiency and productivity. On one hand it would increase efficiency and productivity by evening out tax rates across activities. At the same time, however, it would create a "lock-in" effect that could deter efficient reallocations of capital. It would increase overall taxation of income from capital that would reduce investment, leading to lower productivity. In the absence of offsets, it is likely to reduce efficiency and productivity. But the overall effect on productivity depends crucially on how the revenue raised by the extension is returned to taxpayers as part of a package of complementary measures as well as the detailed design of the measure. It would increase compliance costs for taxpayers.

7. The minority recommendation would increase the horizontal equity and progressivity of the tax system but to a lesser extent than the majority recommendation. It would do little to improve the integrity of the tax system. On the other hand, the minority recommendation would have a less negative effect on efficiency and productivity and would avoid the compliance costs arising from a broad extension. However, it would also raise less revenue.

8. Overall, officials consider that the majority recommendation, if combined with complementary initiatives that improve efficiency and productivity such as the

business package of changes[1], would advance the Government's objectives for the tax system to a significantly greater degree than the minority recommendation.

9. Nevertheless, if the Government decided not to proceed with the broad extension of capital gains taxation, an extension of capital gains taxation to residential rental property and second homes would be an improvement over the current system. An extension to residential rental property only (i.e. excluding second homes) is not recommended as it would be likely to reduce the supply of rental housing.

Part B: Creating a Balanced Package

10. An evaluation of extending capital gains taxation should be made in the context of the complementary measures funded by the revenues raised by the extension. To the extent that there are concerns that raising taxes on capital could impede investment and productivity, a portion of the funds could be directed at balancing measures outside of taxing capital gains itself. Measures could include the business package or other measures of general application such as a reduction in the company tax rate. Concerns about increased compliance costs, especially for small businesses, could be similarly addressed by other measures as proposed in the report (Small Business Tax Measures IR2019/049, T2019/239).

11. Concerns can also be alleviated through design choices in the taxation of capital gains. Simplified rules can reduce compliance costs. Other measures can reduce the impact on desirable business rearrangements.

12. However, care must be taken that the measures do not undermine the achievement of the objectives of the extension. Exemptions can significantly impair the fairness and efficiency objectives; and can add considerably to the complexity of the tax system. In such circumstances, the result could be worse than the status quo. There could be a substantial increase in complexity with limited benefits in terms of fairness, efficiency and revenue gained.

Part C: The Main Building Blocks

13. This part outlines the main building blocks of broad capital gains taxation and seeks Ministers' direction on them. It is intended to allow Ministers to provide guidance to officials as they develop material for a more detailed discussion with Ministers later in the month. Ministers are also invited to indicate what further information they might need to make decisions. The issues raised in this part are summarised in the following table.

Part D: Timing of legislation and phased-in implementation

14. Officials have previously advised Ministers on options for the timing of legislation. Legislation for a broad extension of capital gains taxation introduced in Parliament before the 2020 General Election with effect from 1 April 2022 remains our preferred option. Legislation enacted before the 2020 General Election with effect from 1 April 2021 would be possible, but would carry increased risks of technical errors and complaints of inadequate consultation.

15. The Group's Report raised the possibility of a phased-in extension of capital gains taxation to provide additional time for development of the more complex aspects of the system. If a phased-in implementation were desired, the most feasible first phase would be an extension to residential real estate other than the family home,

[1] As outlined in Joint Report – Tax Working Group – officials' initial advice on potential tax reforms for Budget 2019T2018/3429, IR 2018/800 a business package could include restoring depreciation on buildings, expanding black hole expense deductibility, and reducing restrictions on loss carry-forwards when a company is sold.

with a second phase extending capital gains taxation to all the remaining asset classes.

16. There has been some discussion with Ministers on the issue of timing. It is raised again to confirm views on timing and in case Ministers wish further discussion or information.

Recommendations

We recommend you:

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

2. **Discuss** the issues raised in this report (summarised in the table below) with officials at the Joint Ministers' meeting scheduled for 12 February.

<table>
<tr><th>List of Issues for Discussion with Ministers</th></tr>
<tr><td>In relation to the following list of issues and proposals, Ministers are invited to provide
(i) their current views; and,
(ii) guidance on whether there is any particular additional advice that would be useful for decision-making.</td></tr>
<tr><td>Majority/minority recommendations
The relative merits of the majority and minority recommendations.</td></tr>
<tr><td>Balanced packages
Complementary measures to enhance productivity and reduce impacts on businesses (noting that additional advice will be provided by 22 February).</td></tr>
<tr><td>Tax rates
Taxation at full marginal tax rates.</td></tr>
<tr><td>Realisation taxation
Capital gains generally being taxed when realised.</td></tr>
<tr><td>Inflation adjustment
Capital gains not being adjusted for inflation.</td></tr>
<tr><td>Partial extensions
Partial extensions, other than possibly residential real estate.</td></tr>
<tr><td>Roll-overs
Situations suitable for roll-over (noting that officials will provide further advice on roll-overs by 22 February).</td></tr>
<tr><td>Capital losses
Capital losses generally being deductible against ordinary income, except in circumstances where there are integrity concerns.</td></tr>
<tr><td>Taxation of shareholders and their companies
Taxation of shareholders and their companies (noting that officials will provide Ministers with further information by 22 February).</td></tr>
<tr><td>Effective date
The taxation of capital gains applying to all assets, but only to gains and losses that accrue after the effective date of the tax.</td></tr>
<tr><td>Māori
A specific engagement process with Māori about the impact of any extension of tax on capital gains for transactions relating to Māori collectively-owned assets.</td></tr>
<tr><td>Timing of legislation and phased-in implementation
The following options for implementation.
1. Comprehensive tax, with legislation enacted before the 2020 General Election with effect from 1 April 2021;
2. Comprehensive tax bill introduced to Parliament before the 2020 General Election with effect from 1 April 2022;
3. A phased approach of residential property enacted before the 2020 General Election with effect from 1 April 2021 and the remaining asset classes introduced before the General Election in 2020 with effect from 2022.</td></tr>
</table>

Mark Vink
Manager
The Treasury

Paul Kilford
Policy Manager
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ February /2019

Hon Stuart Nash
Minister of Revenue
/ February /2019

Design Issues in Extending the Taxation of Capital Gains

Purpose

17. This note covers four main areas:

- The majority and minority recommendations;
- Complementary packages;
- Design detail of capital gains taxation; and,
- Timing of legislation and phase-in

18. Ministers are asked to provide guidance in a number of areas that are critical to the design of capital gains taxation. This is not intended to prejudge whether capital gains taxation should proceed, but rather what form it would take if it were to do so.

19. Ministers are also invited to indicate what further information they would require and further options on which they would like information.

20. This report is the first of two on capital gains design. It includes questions on high-level design principles that officials would like to discuss with Ministers at the Joint Ministers' meeting scheduled for 12 February. Although it does not seek final decisions, the answers to these questions be helpful for the drafting of the subsequent report on the detailed design recommendations of the TWG report, scheduled to be delivered to Ministers on around 22 February.

21. On the understanding that Ministers wish to keep to the Government timeline of legislation enacted before the 2020 General Election, our advice is that a Government discussion document would need to be released not later than the end of May. Any later would mean an unreasonably short consultation period before final policy decisions were sought and turned into a bill for introduction.

22. Generally, discussion documents seek to consult on a relatively firm proposal based on Cabinet decisions. In saying this, there are always some areas where options are consulted on and Government will need to reassess the proposal following public feedback to ensure the design still achieves its policy objectives. Our report on 22 February meeting will provide recommendations on any areas of detail that could be 'left open' in the document.

23. To meet this May discussion document timeframe, and also allow the Government to meet its stated objective of making some form of public announcement in April, we consider that Ministerial decisions on these high-level design principles will need to be made not later than the Joint Ministers' meeting scheduled for 26 February, with decisions on detailed design having to follow in very early March. This would allow those decisions to be turned into a Cabinet paper for further coalition party discussions and Cabinet decisions in late March or early April. To this end, our 22 February meeting will also seek agreement to the design principles and details that will inform this Cabinet paper.

24. Any decisions on these high-level design principles that differ significantly from the design proposed by the TWG, or that are significantly delayed, will put pressure on the April announcement and May discussion document release. Any significant deviations from the TWG design may also cause officials to reassess our recommendations on the proposed reform.

Part A: Majority and Minority Recommendations

25. The Report provides both a majority recommendation supporting a general capital gains tax and a minority recommendation suggesting a tax on residential real estate only, with a potential extension to other assets in the longer run. The aim of this Part is to:

- Outline the majority and minority proposals
- Outline key pros and cons of the majority and minority proposals
- Discuss whether the minority proposal is better than the status quo

The majority and minority recommendations

26. The majority of the TWG (8 members) support a general broad tax on capital gains at full marginal rates on a very broad range of assets. This would include gains from all types of land and improvements (except for the family home), as well as gains from shares, intangible assets, and business assets but not personal use assets (such as cars, boats or other household durables). The aim is to make the tax broad; but most personal use assets are left out because they typically depreciate and as a simplification measure.

27. The minority argues for an 'incremental' approach. They argue that residential property (but not the family home) should be made taxable; but that the broader extension should not proceed. The minority is itself split between a recommendation that residential rental property plus second homes be taxable; and an alternative that only residential rental properties be subject to capital gains taxation.

28. Exactly what would be required for an asset to be added under the "incremental" approach to the set of assets where gains are taxed is not made clear. But it appears that the argument is that gains should be taxed when there are predictable expected gains on assets. Residential investment property is judged to be in that class because much less than a 3.5% return on net equity is being taxed. Many banks offer term deposit rates of around 3.5% and are relatively riskless. Given that rental property is a risky investment, equity investment in rental properties would normally be expected to be generating a higher rate of return.

Pros and cons of majority and minority recommendations

29. A number of reports have identified the key benefits of broad capital gains taxation as being:

- Improving the fairness and progressivity of the tax system. The tax increases horizontal equity by taxing different sources of income more equally; and increases progressivity because gains are earned predominantly by the rich;
- Increasing integrity and sustainability. It is difficult to protect integrity if there is a major gap between the company tax rate and the top personal rate without a capital gains tax and this gap is likely to increase over time;
- Increasing the neutrality of investment decisions; and,
- A source of revenue to finance complementary measures that promote Government priorities.

30. Key costs identified were:

- Higher taxes on savings and investment;
- Distortionary costs associated with taxing on a realisation basis especially lock-in and, depending upon options chosen, ringfencing of losses
- Complexity and administration and compliance costs.

31. If one believes that the advantages of a general capital gains tax outweigh the costs, this provides an obvious argument for taxing gains as broadly as possible which is the majority position. If, on the other hand, one thinks that the costs generally outweigh the benefits, this provides a reason for minimising harm by keeping the tax as narrow as possible.

32. The majority of the Group have made the judgement that the benefits of comprehensive taxation of capital gains out-weigh the costs. On the other hand, the minority judgement is the reverse; that the costs outweigh the benefits and so a broad extension of capital gains taxation is not warranted.

33. The minority position is consistent with taxing gains only where there is evidence of consistent gains taking place. It is important to understand the argument that can be advanced in favour of this position. There would be major distortions if there were no tax on assets where there are expected gains such as forestry. Taxing capital income on other assets but not gains on forestry would lead to overinvestment in forestry. But gains on forests are already taxed. The argument goes that we are already taxing gains in most areas where consistent gains can reasonably be anticipated. However, for assets which are neither expected to appreciate nor depreciate, this view would argue that taxing realised gains is very unattractive. It creates lock in and in many countries gains and losses are taxed asymmetrically which creates its own set of distortions.

34. The minority position follows this logic. It recommends taxing gains on residential rental property (and possibly second homes) because there is evidence of consistent appreciation and of income from this asset being undertaxed. (As noted above, considerably less than a 3.5% return on net equity is currently being taxed). But the minority position is that there should be a high burden of proof before adding assets to a schedule of assets where gains are taxed. Hence the suggestion is to stop there.

35. However, there is no evidence provided of whether anticipated capital gains are merely a residential property issue. Evidence from Corelogic for the period 1993 to 2017 shows evidence of consistent appreciation for many forms of land.

Average annual increase in median land value per hectare 1993-2017

Residential	8.4%
Commercial	6.2%
Industrial	7.1%
Dairying	7.1%
Pastoral	8.2%

36. There are also, of course, high profile instances where people have built up very valuable businesses which are later sold for a capital gain. If a major contributing factor is the talent and skills of the entrepreneurs who build up and sell the businesses, this will be another important area where expected capital gains are not taxed. There are well known instances where the entrepreneurs who sell these businesses note the unfairness of them not being taxed on the gains when much lower income people are taxed much more comprehensively on the income they earn.

37. The Minority conclude that in their view a comprehensive approach would impose efficiency, compliance and administrative costs that would not be outweighed by the increased revenue, fairness perceptions, and possible integrity benefits of the broader approach.

38. Reasonable people can come to different conclusions depending upon the relative weight they give to the Government's different objective. As noted elsewhere there are trade-offs among the objectives. Clearly, the minority position gives less weight to fairness and integrity and more to issues of impact on investment and complexity. But the differences underlying the minority thinking and officials' is deeper than that. There are significant differences in the qualitative understanding of the impact of capital gains taxation on each of the criteria.

39. These differences can be summarised as follows:

- **Fairness and Progressivity**– the minority refers to "fairness perceptions" suggesting that they think that it is perceptions of fairness rather than fairness itself which is the key issue. An important question for the Government is the importance it places on those with similar incomes paying similar amounts of tax and on taxing income in a progressive fashion so that those with greater ability to pay end up paying a greater proportion of their incomes in tax. A broad capital gains tax assists with both objectives.

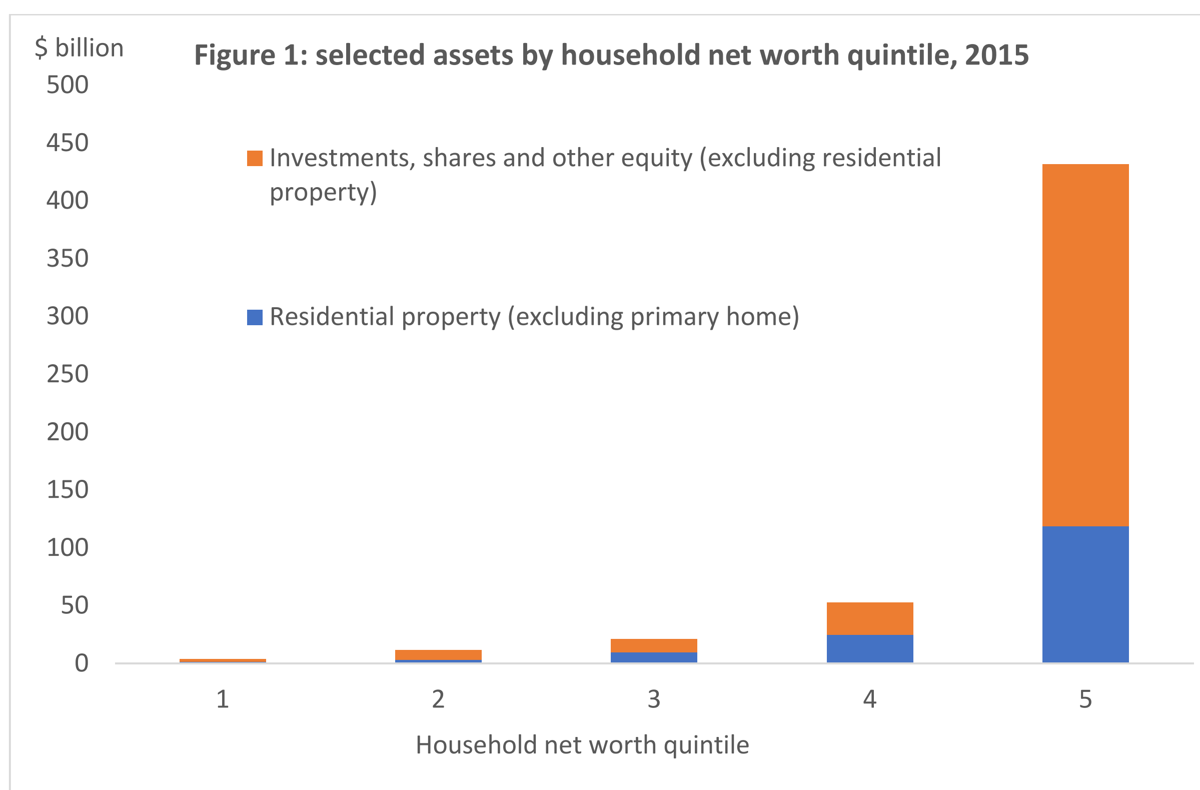
- **Integrity** – the minority refers to "possible integrity benefits". There is no discussion of what these benefits might be. A key goal of New Zealand's tax system is to tax income at progressive rates in ways which cannot easily be sidestepped. The non-taxation of capital gains undermines the integrity of the tax system. It makes it easier for labour income to be converted into untaxed capital gains, for companies to be used to shelter the income of high-income earners from higher rates of personal tax and for multinational firms to sell their IP offshore to facilitate lower payments of tax in New Zealand. Taxing capital gains directly helps address these issues.

- **Efficiency and Productivity** – the minority fears that capital gains taxation will damage entrepreneurship, experimentation and innovation and capital markets. While gains on domestic shares would be taxed, New Zealand's full imputation regime continues to provide a substantial incentive for people to invest in domestic equities. Capital gains on shares are taxed in the vast bulk of OECD countries and many have thriving share markets and entrepreneurship. Increased taxation of capital income can reduce investment. If potential productivity impacts are a concern to the Government, they have the option of using a portion of the revenues raised by capital gains taxation to productivity enhancing measures that would improve the efficiency of the tax system.

- **Complexity** – the minority is concerned that capital gains taxation will increase complexity. Provisions will be introduced where possible to minimise complexity, but inevitably there will be an increase. The minority report cites anecdotal evidence of increases in compliance costs of 30%. In contrast, studies of compliance costs of capital gains in Australia, measured compliance costs more in the order of 2% of total compliance costs. A package of compliance reducing initiatives in the general tax system targeted at small businesses has been proposed in the report Small business tax measures, IR2019/049, T2019/239.

40. The majority and minority recommendations differ in their impact on progressivity. There is limited data in New Zealand on the distribution of wealth and what assets the wealth is comprised of. The best information we have is from the *Household Economic Survey*. By making adjustments to that data to find the distribution of ownership of investments, shares and other equity (excluding residential investment property) (which would face no extension of taxation of capital gains

under the minority view) and residential rental property (which would), we can make judgments about the relative progressivity of each option[2].



41. As one might expect and as can be seen in Figure 1, most investments, shares and other equity (excluding residential investment property) (86%) and residential investment property (75%) are held by the wealthiest quintile of households.

42. However, investments, shares and other equity (excluding residential investment property) make up 41.1% of the wealthiest quintile's assets, while residential investment property only makes up 15.6% of this quintile's assets. Some investments, shares and other equity (excluding residential investment property) will be bonds and debt securities that are already comprehensively taxed, but much of the wealth will be shares in businesses and other investment funds. As a result, not only are most of the investments, shares and other equity (excluding residential investment property) that would be exempt held by the wealthiest quintile, but this quintile's portfolio is much more skewed toward these assets than investment property. Accordingly, the minority recommendation would increase progressivity to a lesser extent than would comprehensive capital gains taxation.

43. Key advantages and disadvantages of the minority recommendation relative to comprehensive capital gains taxation are summarised in the following table.

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[2] Residential rental property includes residential rental property equity in trusts, investment property equity in unlisted and unincorporated businesses. Due to data limitations the investment property equity in unlisted and unincorporated businesses will also include non-residential property held in private businesses. As a sensitivity analysis we have looked at the results when this item is excluded, and it does not materially change the results. Financial assets include pension funds, bonds and other debt securities, equity in own unincorporated enterprises, shares and other equity, mutual funds and other investment funds, life insurance funds and annuities, and other household financial assets

Estimates are approximations based on survey sample data and therefore subject to uncertainty. Total estimated assets in the Household Economic Survey do not exactly match estimates from aggregate data, likely owing from survey under-coverage of high-wealth households and/or under-reporting of assets in survey responses

Comparison of the Majority and Minority Recommendations

Objective	Broad base	Residential rental or residential rental plus second homes only
Revenue over 5 years	$8.3 billion	$2.8 billion[3]
Impact on packages	• Provides significant funds for balancing initiatives in package; • Could fund productivity measures and/or fairness measures • $4.0 to $5.3 billion for fairness measures after Business package.	• Less need for business package (although business package desirable on own account) • Funds could be directed at fairness measures
Progressivity	• Substantial increase in progressivity • Financial assets concentrated in upper income percentiles • Taxing financial and business assets targets increased taxation to upper income earners	• Smaller progressivity benefit • Capital gains on financial and business assets which are concentrated in the upper wealth quintile are still untaxed
Horizontal equity	• Greater improvement • More closely aligns capital income taxation to taxation of other income	• Modest improvement • Evens out taxation of residential real estate with fully-taxed assets • At the same time means harsher treatment for residential real estate than most other appreciating assets. • Under-taxation of capital gains on business and share assets remain
Efficiency and Productivity	• Capital gains taxation raises tax on capital income reducing incentive to invest and productivity • By itself, likely to reduce efficiency and productivity although net effect with business package could be productivity enhancing • Evens out taxation across activities with different percentage of capital gains • Lock-in effect	• Like land tax, relatively efficient (non-distorting) source of revenue • Evens out taxation of rental residential real estate with fully-taxed assets • Under-taxation of capital gains on business and share assets remain • Lock-in effect on taxed assets

[3] Of which about $0.4 billion comes from taxing second homes. This revenue estimate is preliminary and indicative and may change following receiving further information or quality assurance. The costing is in tax years and will be different once converted into fiscal years.

Sustainability	• Broadening tax base and removing untaxed income improves sustainability of tax base. • More robust if divergence between company and personal tax rates	• Broadens revenue base • Does not respond to divergence in tax rates
Integrity	• Reduces scope for companies to be used to shelter income from higher rates of personal tax • Stops conversion of income into capital gains • Reinforces fairness and sustainability gains	• No effect on integrity outside of labour component of rental residential housing appreciation • Need for rules for land-rich companies
Complexity	• Increases compliance costs for all taxpayers earning capital gains • Valuations of existing assets when tax comes into effect complex especially for business assets and private shares • Complex adjustment for shares of members of corporate groups	• Much smaller increase in compliance costs • Increases compliance costs for landlords or landlords plus those with second homes. • Valuations of existing assets less complex than other business assets and private shares
Coherence	• More coherent due to more comprehensive definition of income	• Leaves fundamental incoherence of exempting a portion of income
Housing affordability	• Some small increase in rents and some fall in price of houses may occur	• If it applies only to rental property likely negative. Taxing gains on residential rental, but not second homes, will tend to reduce housing supply. • If also applies to second homes, some small increase in rents and some fall in price houses may occur

Is the minority position better than the status quo?

44. Extending taxation to capital gains to residential property makes progress towards most of the Government's objectives, provided that second homes are included in the tax base. If second homes are not included there is the risk that taxpayers anticipating capital gains would remove houses from the rental market, leaving them vacant and reducing housing supply.

45. Gains on residential rental property and second homes are an important source of untaxed income. Around one third of capital gains are expected to be on residential rental property and second homes. Gains on this would become subject to tax. It would remove the bright-line test for residential investment property. (This is a relatively unattractive tax because it can be sidestepped by holding such property beyond 5 years).

46. While some new distortions would arise, e.g., between residential property and other property, it seems doubtful that associated distortions would have very large efficiency costs. There tend to be relatively low deadweight losses associated with

taxes on land. It seems likely that this tax would have a lower efficiency cost than many other taxes yielding comparable revenues.

Part B: Creating a balanced package

47. Concerns have been raised that taxing capital gains could reduce productivity and inhibit certain business development, particularly for small businesses. As noted, increasing taxation of capital income would likely impair productivity, on its own. However, the assessment of the impact of broad capital gains taxation on the objectives of the Government depends critically on how the funds raised by the extension are used as part of the complementary package of changes and on the detailed design of the tax.

48. There are inevitable trade-offs between the objectives. For example, taxing capital gains increases progressivity, improves horizontal equity, and contributes to the integrity of the tax system. But it has effects on efficiency and productivity which go in different directions. On one hand it improves efficiency and productivity by evening out rates of tax across sectors, improving the allocation of investment. On the other hand, lock-in will reduce capital mobility and there is an increase in taxation of income from capital that, this will reduce the total amount of investment. On balance we expect that there would a net loss in productivity. However, this judgement does not take into account the use of the funds raised. If sufficient portion of the funds are used in ways that enhance productivity, the Government can achieve significant fairness gains without impairing overall productivity. Finally, compliance costs will increase.

49. Complementary measures that address productivity and compliance concerns could include:

- The package of business measures previously provided that were identified by the Group;
- A package of small business compliance measures outlined in the report Small business tax measures, IR2019/049, T2019/239; or,
- Other general measures to support productivity such as a reduction of the company tax rate.

50. In addition, there are detailed design choices that can mitigate negative effects on business activity and compliance costs. These include generally allowing capital losses to be deducted against ordinary income; allowing roll-overs in appropriate circumstances; and developing simplified methods of compliance where possible.

51. On the other hand, there are other possible provisions, such as exemptions, that could undermine the effectiveness of capital gain taxation in achieving its fairness and integrity objectives. Introducing a capital gains tax with substantial holes in the base could incur significant extra compliance costs while failing to meet the Government's goals for fairness, integrity and efficiency, and while raising less revenue for complementary measures.

52. In the opinion of officials, there are considerable advantages of using a combination of careful design of broad capital gains taxation plus introducing complementary measures in the general tax system, rather than compromising the design of capital gains taxation.

Part C: The main building blocks

53. This Part outlines the major design choices facing the Government in implementing broad capital gains taxation. In assessing the impact of capital gains taxation, the

devil is in the details. How taxing capital gains would affect taxpayers depends critically on detailed design decisions of policy-makers. The challenge is to design provisions, as part of a consultative process, that can be complied with and do not unduly interfere with business decisions; without compromising the Government's goals of fairness, efficiency and integrity of the tax system.

54. Careful design can help the Government make the necessary trade-offs among its objectives. At the same time, design decisions can mitigate the compliance costs and potential negative effects of raising taxes on capital.

55. The following provides background on the main structural issues for background purposes and asks Ministers for direction in a number of critical areas.

56. Capital gains taxation has been successfully implemented in most OECD countries. New Zealand can learn from other countries' experiences. A critical goal of consultation will be to respond to the legitimate concerns of taxpayers in crafting rules that simplify the application of the tax and ensure that unintended anomalies do not occur.

57. Some commentators suggest that the Group recommendations for capital gains taxation would be unduly harsh, complex or unfair compared with capital gains taxation in other countries. The recommendations of the Group fall within the range of provisions adopted in other countries. The general characteristics of capital gains taxation are common across countries; and the Group recommendations are, for the most part, standard practice. At the level of detail, countries are more or less stringent in different areas. This is also true of the Group's recommendations. The rules are more stringent than most in some areas but there are other countries with more stringent rules. In other areas the rules are less stringent than in many countries. This reflects the common sense, practical approach adopted by the Group and supported by officials.

Taxation at full marginal tax rates

Group recommendation

58. The Group has recommended that capital gains be combined with other income and be taxed at full marginal tax rates.

Comments

59. Relative to the majority recommendation, partial taxation of capital gains would have significant disadvantages. It would:

- Provide less revenue to fund Government priorities as part of a complementary package of initiatives;
- Be less progressive, leaving higher income taxpayers earning capital gains facing lower tax rates than other taxpayers;
- Be less horizontally equitable as taxpayers with similar incomes, but with and without capital gains, would pay different amounts of tax;
- Be more complex as it would retain the differential in taxation between income and capital gains:
- Be less effective in evening out investment incentives across assets; and,
- Be less effective in improving the integrity of the tax system as there would still be incentives to convert ordinary income to capital gains.

60. The complexity issue is worth emphasis. One of the perennially difficult administrative borderlines that leads to contention between administrators and taxpayers is the distinction between income and capital gains. Taxing capital gains at full rates and allowing capital losses to offset other income reduces the circumstances where it is necessary to distinguish between income and capital gains. This is a major operational simplification for taxpayers and tax administrators.

61. There would be benefits from a lower tax rate, including:

- Less taxation of certain types of capital, reducing negative effects on productivity;
- Lock-in would be reduced, promoting greater flexibility in allocating capital; (however allowing roll-overs can mitigate some lock-in issues, for example with corporate reorganisations); and,
- Reduced distortions arising from asymmetric treatment of gains and losses; (however, allowing losses to be offset against ordinary income addresses this issue directly).

62. Some other OECD countries tax capital gains at lower tax rates than other income or with a partial income inclusion. This raises the concern that New Zealand could be treating capital gains more harshly than some other jurisdictions. This must be seen in context. Other countries have higher top marginal tax rates, so that the net difference in tax rates on capital gains is smaller than would otherwise occur. For capital gains earned in companies and distributed to individuals, New Zealand would be at the low end of effective tax rates due to imputation which relieves double taxation of income earned through companies. For capital gains earned directly by individuals, New Zealand would be at the higher end of effective tax rates, but a significant number of countries would have effective rates in the range of 25% to 30%[4], and some countries such as Germany, Italy, Ireland and Denmark apply tax rates of 33% or more. To the extent that this is a disadvantage, New Zealand's proposed relatively generous loss offset rules would provide an important counter-weight.

63. The rate of tax to be applied to capital gains is a fundamental building-block of capital gains taxation. Partial inclusion of capital gains or taxing at a lower tax rate implies radically different legislation design, administration and compliance. The problem is the need to separate out costs and revenues in a separate computation of capital gains rather than integrating it in the general calculation of income.

Officials' position

64. Officials believe with a top marginal tax rate of only 33% it is reasonable to tax capital gains at full rates. At higher tax rates, concerns about lock-in and any asymmetry in taxation of gains and losses could make a lower tax rate desirable.

Realisation taxation

Group recommendation

65. The Group recommended that capital gains would be taxed generally when there is a change of ownership or sale of the asset or when the asset is deemed to be sold.

[4] Harding, M. and M. Marten (2018), "Statutory tax rates on dividends, interest and capital gains: The debt equity bias at the personal level", OECD Taxation Working Papers, No. 34, OECD Publishing, Paris.

Rollovers (discussed in next section) should be available in certain circumstances that would otherwise be a realisation event.

Comments

66. All countries that tax capital gains do so on a realisation basis. The theoretically pure option of taxing gains on accrual is rejected due to the complexity of annual valuation of assets, and the unavailability of cash to pay the tax on illiquid assets.

67. Realisation taxation raises issues. It defers taxation of capital gains relative to income on assets whose income is taxed annually meaning that the effective tax rate on capital gains remains below that for income on other assets. (The table shows the extra accumulated value of a capital asset of 100 earning a five percent return that is taxed at realisation, as compared to the accumulated value of an asset such as a bond that is taxed as the income is earned.)

Accumulated Value of an Investment of $100 (years 1 to 40)							
	1	5	10	15	20	30	40
Accrual Taxation	103	118	139	164	193	269	374
Realisation taxation	103	119	142	172	211	323	505
Realisation/accrual	100%	101%	102%	105%	109%	120%	135%

68. Taxpayers may have the option of when to sell assets allowing them to advance losses while deferring income. Rules may be needed to prevent artificial losses due to churning or self-dealing. Finally, realisation taxation (a tax benefit to investors) leads to the problem of lock-in, where tax payers can reduce taxation by holding on to assets they would otherwise sell in the absence of taxation.

Officials' position

69. Officials agree that capital gains should be taxed as realised and that deemed realisations should be made when there is a change of use or a migration.

Adjustment for inflation

Group recommendation

70. The Group recommended that capital gains not be adjusted for inflation.

Comment

71. Taxation of nominal gains means that the inflationary component of income is taxed for all types of capital income. In theory capital income should be adjusted for inflation. Countries have examined introducing inflation adjustments on numerous occasions, but, with a few exceptions of high inflation economies, have opted to continue to tax nominal income. Inflation adjusting only certain types of income would be highly distortionary and subject to tax planning.

72. Among categories of capital income, capital gains is least affected by inflation since the deferral of taxation due to realisation taxation avoids the compounding effect of annual taxation of income that applies to income such as interest.

73. The following table shows the effect of inflation on taxation of capital income on a bond, which is fully taxed as income accrues and an asset earning a capital gain which is only taxed at the end of the period. The table compares the after-tax value of the investment compared to the after-tax value of the investment had the tax base been inflation adjusted. Assuming a 5% nominal return and an inflation rate of 2%, the after-tax value of the fully taxed investment falls further behind the inflation adjusted asset over time. But the capital gains asset does not fall as far and after enough time the after-tax return actually exceeds the return on the inflation adjusted asset. The benefit of deferred realisation taxation exceeds the benefit of inflation adjustment.

Accumulated Value of $100 Investment (years 1 to 40)							
	1	5	10	15	20	30	40
Indexed	104	122	148	180	220	325	482
Full accrual	103	118	139	164	193	269	374
Full realisation	103	119	142	172	211	323	505
Full accrual/indexed	99%	97%	94%	91%	88%	83%	78%
Full realisation/indexed	99%	97%	96%	96%	96%	99%	105%

Officials' position

74. Officials agree that capital gains should not be adjusted for inflation

What is taxed

Group recommendation

75. The majority of the Group has recommended a broad extension of capital gains taxation applying to most assets. The system would include gains from all types of land and improvements (other than the family home), shares, intangible assets and business assets. The principal exclusions are assets acquired for personal purposes, other than secondary residences. Gains on other financial assets, such as bonds, are already taxed under the Financial Arrangements rules; and most overseas equity investments are taxed under the FIF rules.

Comments

76. The intention of the recommendation is broad taxation of assets expected to give rise to capital gains. Assets were specifically listed to avoid problems of unintended application of the tax

77. Most personal assets would be outside the tax base. The only category of personal assets to be subject to tax on their capital gains would be real estate other than the family home. Taxed assets would include second homes. Real estate assets can give rise to substantial capital gains, in large part due to increases in the price of land.

78. Personal-use assets, such as cars, tend to depreciate with use and so would not be expected to give rise to capital gains. Losses on the other hand would be assumed to result from depreciation resulting from the use of the assets, a form of

consumption, and should not be deductible. Accordingly, these assets would not be subject to capital gains taxation. Potential exceptions to this could be art, jewellery and some collectibles, which can generate significant capital gains. Traders in such assets would be taxable under ordinary income tax concepts.

79. An extension of taxation to personal assets where gains might be expected, perhaps over a threshold, was considered, but was not recommended by the Group. While a number of countries tax personal-use assets, officials concur that such taxation is unlikely to be worth the additional compliance burden. This is an example of an area where New Zealand would be less stringent than some other countries.

80. The Report summary and covering letter suggests that there are partial extensions of capital gains taxation to some assets but not others that could be considered. Partial extensions, other than the minority recommendation are not discussed in the body of the Report. The Report does not offer suggestions of what these might be.

81. The minority recommendation would extend capital gains taxation only to rental residential properties (possibly including second homes). While this option appears technically feasible, it would provide significantly fewer funds to pursue Government priorities and would substantially fail to address fairness and integrity concerns. The minority report is discussed in greater detail in Part A.

82. Partial extensions (other than to residential property) would generally raise significant implementation issues and can treat similar taxpayers differently depending upon which assets they hold.

83. Potential partial implementations could be:

- **Residential property**, (residential rental property plus second homes if desired), is less mingled with other assets than other business assets. To the extent that there is separation, then problems of separate valuation and streaming costs and revenues would be minimised.

- **Targeting specific business assets** including land and real estate would be more problematic technically and have increased compliance costs. Most of the rules needed for general taxation would be required. Moreover, they would be very problematic from an implementation point of view. There would likely be complex borderlines to police. Valuations would require taxpayers to disentangle the value of taxable from non-taxable assets in a business when the business is sold. Expenses would need to be allocated between taxable and non-taxable activities. Taxpayers with equivalent economic situations could find that they had different tax outcomes depending upon how their affairs were organised. This could cause distortions in investment patterns and business organisation.

- **Private company shares** raise complex technical issues that would need to be resolved. Moreover, it is difficult to tax the shares effectively without taxing business assets at the same time, at which point partial extension would make little sense.

84. Effective delivery of partial extensions other than residential real estate raises significant problems. The problems would become more salient if the full extension of capital gains taxation was delayed or abandoned.

Officials' position

85. Officials concur with the recommendation that there be a broad extension of capital gains taxation.

86. Officials did not have an opportunity to fully analyse or report on partial extensions to the Group.

87. Exempting categories of income earning assets would generally fail to achieve the objectives of the Government and, if extended beyond residential property, might not be possible to implement in a reasonable timeframe.

Roll-overs

Group recommendation

88. The Group proposed that roll-overs of capital gains taxation be provided for certain life events such as death and separation and for certain Maori collectively-owned assets. They have also proposed roll-overs for a number of business situations, such as involuntary realisation events where the funds are reinvested in a similar asset, certain business restructuring, and reinvested funds of small businesses.

Comments

89. Roll-overs allow a deferral of the taxation of capital gains when certain realisation events occur. The taxation of capital gains is deferred, the cost base of the asset is maintained, and taxation only occurs when a subsequent realisation event occurs that does not qualify for a roll-over.

90. Roll-overs can soften the impact of capital gains taxation, preventing taxes from inhibiting desirable business re-arrangements or in circumstances where taxation might impose an undue hardship. Roll-over provisions vary enormously across countries. Used judiciously they can smooth out the operation of the tax system. On the other hand, if used indiscriminately, roll-overs can undermine the effectiveness of capital gains taxation in achieving its goals of fairness and efficiency; and can increase complexity as the rules need to be targeted and complied with.

91. Different roll-overs respond to different policy concerns, including:

    - Involuntary realisation events beyond the taxpayer’s control; such as expropriation, or an asset that is destroyed, provided that the disposal proceeds received are reinvested in a replacement asset;
    - Business reorganisations with the same ownership maintained, such as the incorporation of a sole proprietorship. In this case, there has been a change of ownership in form, but not in substance;
    - Relationship property transfers between spouses or as part of a relationship property settlement.

92. However, roll-overs can increase lock-in as capital gains accumulate untaxed. The provision of roll-overs without strict criteria can be a precedent for further requests that can undermine fairness if they allow taxation of significant accumulations to have taxes to be deferred.

93. Allowing extensive roll-overs in combination with generous loss offset provisions (see next section) could open up the possibility of timing mismatches between losses and income.

Officials position

94. Officials generally agree that there should be some life event roll-overs and a reasonably limited set of business rollovers, addressing involuntary realisation events and business reorganisations. Care must be taken beyond that as roll-overs can frustrate attaining the objectives of capital gains taxation. At the same time, roll-overs can mitigate some of the negative effects on business operations.

Capital Losses

Group recommendation

95. In general, the Group recommends that capital losses be deductible against other income. However, there are a number of circumstances where losses should be restricted, or other measures introduced to protect the integrity of the tax system.

Comments

96. In most OECD countries[5], capital losses can only be deducted against capital gains. This is intended to prevent taxpayers from using capital losses to shelter other income from tax while deferring taxation of capital gains on assets that have increased value. Such countries also tend to tax capital gains at different rates than ordinary income. However, some countries only ring-fence losses on shares[6] and there are targeted reliefs in other cases. The Group has proposed that most types of capital losses can be deducted without restriction. The proposed New Zealand treatment of losses would be among the most liberal among OECD countries.

97. It is important to note that the New Zealand Venture Capital Association (NZVCA) supported capital gains taxation because it would allow deductions for capital losses in start-ups.

98. Allowing losses to be deducted would have beneficial effects in the taxation of risk. A particular problem with loss restrictions is that they treat gains and losses asymmetrically. The government shares in gains through taxation; but does not share fully in losses if they are restricted. This asymmetry creates a bias against risk by discouraging risky but potentially high-return investments. The bias against risk can be eliminated by removing the restriction. Some extra volatility in Government tax revenue over the business cycle will occur as a result.

99. Nevertheless, as noted by the Group, there will be situations where some form of restriction may be appropriate. These situations result from realisation taxation and the ability of taxpayers to choose when to cause a realisation event for an asset with an accrued loss. Problems can occur for liquid assets where losers can be sold while gainers held; or when there has not been a real third-party sale of the asset. Accordingly, the Group recommended that losses from portfolio-listed shares be ring-fenced.

100. There are other types of transactions where a loss restriction is appropriate. For example, an asset with an accrued loss can be sold to a related party; or an asset with a loss can be sold, and then an identical replacement asset immediately repurchased. In both cases there has not been a real change in the ownership of assets, but a loss has been triggered. Fairly standard provisions exist in other countries to deal with these problems.

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[5] Norway and Switzerland do not.
[6] Japan and Mexico

Officials' position

101. Officials agree that capital losses should be deductible against ordinary income as a general principle, (although some exceptions are necessary, such as portfolio shares and other liquid assets). Officials are examining whether to recommend a further extension, compared to the Report, of the types of losses that would be deductible against ordinary income. For example, the Group has recommended that losses on assets valued on Valuation day be restricted due to problems in valuation.

102. Officials are also examining other situations where some form of loss restriction may be appropriate.

Taxation of shareholders and their companies

Group recommendation

103. The Group noted that the combination of taxation of income in a company and capital gains on sales of shares at the shareholder level can lead to the possibility of double taxation or double losses in some circumstances. Some technical responses were suggested.

Comments

104. Many of the most contentious issues in developing provisions for the taxation of capital gains, other than taxing capital gains at all, involve issues of taxing shareholders and their companies. New Zealand has an advantage over most other countries in this area due to the imputation system and its reasonably close alignment of company and personal tax rates. Arguably, taxing capital gains completes the existing system, providing a better balance, and improving fairness and integrity.

105. The Report raised the issue that double taxation and losses, once in the company and again at the shareholder level, can occur when capital gains are taxed. Issues of double taxation and deductions are nothing new. All countries' tax systems, including New Zealand's current system, have issues in this area.

106. There are a variety of inconsistencies in the level and timing of taxation due to the separate taxation of shareholders and their companies. These inconsistencies are the basis of many of the tax planning problems that undermine the integrity of the current tax system. For example, in the absence of capital gains taxation, sales of shares instead of paying dividends allows taxpayers to defer, and in some cases eliminate, taxation by using dividend avoidance schemes.

107. New Zealand's imputation system, which ensures that personal tax rates are paid on distributed income earned through companies, puts New Zealand in a better place with respect to these issues than other countries.

108. Capital gains taxation further improves the system as it eliminates some of the inconsistencies which provide opportunities for tax avoidance and improves the taxation of accruing but unrealised gains. Arguably it brings a better balance into the tax system.

109. Because of imputation, New Zealand companies face fewer problems of double taxation. New Zealand public companies have higher than average pay-out ratios of retained earnings. Private company taxpayers can use simple self-help measures to avoid problems; for example, by paying taxable bonus issues to avoid double taxation of retained earnings.

110. In some cases, self-help may not be available. In those cases, over-taxation could occur. Otherwise desirable economic transactions might be inhibited. In other cases, double losses may arise. Where these situations occur, provisions may be necessary that alleviate the problem.

111. For example, as suggested by the Group, the continuity rules for imputation credits and losses should be re-examined in the context of capital gains taxation. Officials are examining this area. Care would be needed to ensure that relaxation did not open up opportunities for trading in unused credits and losses. Risks may be exacerbated when groups of companies are involved

112. Capital gains taxation changes the nature of the issues in this area; and justifies an examination of consequential measures to reduce unintended effects, even as it fixes other issues with the current system.

113. Finally, applying capital gains taxation within corporate groups raises complex issues, involving the possibility of either over- or under-taxation. It will be necessary to have careful consultation to develop the necessary legislation.

Officials' position

114. The introduction of capital gains taxation of shares addresses serious integrity issues that arise currently around share-holder and company taxation. Officials agree that the taxation of capital gains changes the issues in this area and that some adjustments to current rules, such as the continuity rules, may be warranted. They are examining other possible amendments to mitigate unintended effects of introducing capital gains taxation. This will be an important area for consultation.

Effective date (valuation day)

Group recommendation

115. Taxation of capital gains would apply to all assets, but only to gains and losses that accrue after the implementation of the tax.

Comment

116. Only taxing gains and losses that have accrued after the effective date avoids retroactive taxation. However, it requires a valuation for all existing assets to determine the gains that have accrued after implementation.

117. A valuation day avoids the investment biases that occur with alternatives such as grand-parenting assets. (That is, taxation only applies to assets purchased after the implementation of the tax.) Moreover, the recommended approach produces substantially more revenue over the first five years and avoids complexities necessary to ensure that assets which change over time are deemed to enter the tax base. Australian experts have also advised that the grandparenting approach (which was used in Australia) introduces a significant amount of complexity and imposes compliance costs as an entirely different set of rules is required to deal with grand-parented assets compared to other assets.

118. The major concern with a valuation day is the complexity of establishing the values on the day. For some assets, such as public shares, valuation can be taken directly from publicly available data sources. For others, such as property, publicly available data can be used as a basis for valuations. But others, such as private businesses can have unique characteristics that require more complex valuations. This is a complicated process. Various optional approximations are being examined to reduce compliance costs for hard to value assets.

Officials' position

119. Officials agree with a valuation day approach and are examining ways to minimise compliance costs.

Māori taxation issues

Group recommendation

120. The Group has noted in several places that the treatment of assets in collective Māori ownership (such as Māori Freehold Land and assets held by post-settlement governance entities) warrant special consideration under any extension to the taxation of capital gains. In some cases, the Group has recommended consideration of an exemption (for example, the disposal of Māori Freehold Land or interest in that land), and in others the Group has recommended consideration of rollover relief. In all cases, the Group suggests that solutions be developed through further engagement with Māori under the GTPP "to ensure the rules achieve the intended policy".

Comments

121. Treatment of transactions related to assets in collective Māori ownership will need careful consideration in the context of extended capital gains taxation in light of ongoing impact of historical Crown actions relating to these assets and the impact of legislation, such as Te Ture Whenua Māori Act, on how they are managed and the circumstances around sales. Options should be considered from a tax policy perspective and also with Crown-Māori relationship objectives and principles in mind, including any potential compounding effects across the Government's current policy programme.

122. Participants in last year's process indicated that they would like further engagement as the policy work progresses and key design features have been determined. Getting as clear as possible about potential impacts will enable well-informed advice to Ministers on likely issues and options and timely decision-making. Officials are working with Crown Law so that we can continue to advise whether the approach is consistent with the Crown's obligations under the Treaty of Waitangi to act in good faith.

123. Any engagement will need to allow for the detailed development of specific treatment options to meet the Government's timeline for implementing the tax change, while genuinely considering other approaches to ensure it is a good faith process.

Officials' position

124. We would recommend further engagement with Māori on any extension of taxing capital gains to ensure that the potential impacts for collectively-owned assets and entities are understood, and any unintended effects can be anticipated and addressed, as appropriate.

125. Officials will provide more specific advice about how an engagement process achieve these objectives and, if this is agreed, will provide updates at each stage of the process about any implications for the timeframe for the tax change and, if necessary, how any alternative approach they might be addressed through the policy and legislative process.

Part D: Timing of legislation and phased-in implementation

Group recommendation

126. The Report did not analyse or make recommendations on a phased-in implementation. The letter from Sir Michael to Ministers indicated that the "Government also has options around how to stage the timing of introduction and whether to phase in the inclusion of asset classes." The TWG report itself also notes that the Government "has options about how to stage the timing of introduction."[7]

Comments

127. Phased-in implementation has been suggested to address concerns about achieving a successful implementation within compressed timelines. As alluded to in our report dated 1 February (T2019/113 / IR2019/041 refers), on the assumption that a comprehensive tax is preferred, officials consider there are three main implementation timing options:

- *Option 1* - Comprehensive tax on the Government's proposed timeline of legislation enacted before the 2020 General Election with effect from 1 April 2021;
- *Option 2* - Comprehensive tax bill introduced in Parliament before the 2020 General Election with effect from 1 April 2022;
- *Option 3* - A phased approach, with residential property (other than the family home) enacted before the 2020 General Election with effect from 1 April 2021 and the remaining asset classes introduced before the General Election in 2020 with effect from 1 April 2022. This split between residential property and the rest, rather than any other dividing line, is for the reasons noted in the "what is taxed" section of this report.

Officials' position

128. Officials have previously advised that our preference is for Option 2, which would allow for consultation both on the design detail and possibly some key aspects of legislative drafting before any amendment bill was considered by Select Committee.

129. We have also previously advised that we could meet the timelines for Option 1 if necessary. Both these pieces of advice still stand.

130. In saying this, we reiterate that Option 1 significantly increases the risk of:

- Technical errors in the legislation that will require remedial amendment; and
- Complaints from stakeholders that any consultation process is inadequate for what will be an important and complex set of legislative amendments.

131. 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. The TWG also noted that this timeline was "challenging".

132. If Ministers are considering a phased approach, officials consider that Option 3 has the following advantages when compared with Option 1:

[7] Tax Working Group Final Report, Volume I, paragraph 13.

- There is clearly significant stakeholder concern over the details of any proposals. Extra time would allow a more thorough consultation process, improving the overall quality of the bill at introduction and easing these stakeholder concerns. Shorter timeframes also put more pressure on the process to understand impacts for Māori collectively-owned assets and associated decisions by the Government, which is necessary to ensure that the Crown has acted in good faith in relation to its Treaty partner;

- The boundary between residential property and the rest is relatively neat, which would make extending income tax to that class of assets relatively simple and also minimise the need for temporary measures;

- Having a delay of only one year would lessen the pressure on temporary measures anyway because it limits the benefits of taxpayers structuring to avoid the tax;

- Introducing a comprehensive bill to Parliament before the 2020 General Election would, in our view, meet the Government's objective of providing certainty to taxpayers on the design of the tax;

- Although it would generate less revenue in earlier years than Option 1, it would still tax a large asset class in 2021-22 year and therefore generate more revenue that Option 2.