Inland Revenue
Te Tari Taake
POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax Policy Report: Further information on potential distributional impacts of extending the taxation of capital gains

Date:	11 February 2019	**Report No:**	T2019/242 IR2019/068
		File Number:	SH-13-7-9

Action Sought

	Action Sought	Deadline
Minister of Finance (Hon Grant Robertson)	**Note** the contents of this report	None
Minister of Revenue (Hon Stuart Nash)	**Note** the contents of this report	None

Contact for Telephone Discussion (if required)

Name	Position	Telephone		1st Contact
Mark Vink	Manager, Tax Strategy	s9(2)(a)	N/A	
Phil Whittington	Senior Policy Advisor, Inland Revenue		s9(2)(a)	

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

Return the signed report to Treasury.

Note any feedback on the quality of the report

Enclosure: Yes - 3 Distributional analysis and incidence (Treasury:3993062v1)
c Distributional analysis (Treasury:3947407v1)

Tax Policy Report: Joint Report: Further information on potential distributional impacts of extending the taxation of capital gains

Executive Summary

This report responds to a request from Ministers for further information on the potential distributional impacts of extending the taxation of capital gains, including on the number of individuals that could be directly affected.

Specific data relating to capital gains in New Zealand is highly limited. Therefore, all of the impact analysis in this report necessarily relies on approximations and assumptions. Accordingly, all the results should be considered as indicative only.

The information in this paper summarises previous information provided to the Tax Working Group in the Secretariat papers on *Distributional analysis* and *Distributional analysis and incidence*. These are attached. This report also provides new analysis including:

- Further breakdowns of the estimated impact of taxing capital gains across net worth deciles (Figures 5-7)
- The proportion of residential assets held by each household net worth decile compared with non-residential assets potentially subject to an extended taxation of capital gains (Figure 8)

Some of this new analysis has been prepared relatively quickly and should be considered preliminary.

The key results from the analysis are:

- A broad-based extension of the taxation of capital gains (as recommended by the majority of the Tax Working Group) would be progressive. In particular, the additional tax would be paid mostly by those with high wealth.
- An extension of the taxation of capital gains applying solely to residential investment property (as recommended by a minority of the Tax Working Group) is also likely to be progressive. However, it is likely to be less progressive than a broad-based extension of the taxation of capital gains.
- Taxing capital gains is likely to have an uneven impact across industries. For small and medium enterprises, most tax from capital gains are expected to be paid by the property, agricultural and finance sector.

We intend to discuss this report further with your office to determine whether there is further information we can provide that could assist you in decision-making, including in relation to distributional analysis of potential packages for Budget 2019. We will also be available to discuss further with you, if required, at our meeting scheduled for 13 February 2019 on the Government's response to the Tax Working Group.

Recommended Action

We recommend that you

(a) **note** the contents of this report

Noted *Noted*

(b) **discuss** this report with officials, if required, at the meeting scheduled for 13 February 2019.

Mark Vink
Manager, Tax Strategy

Phil Whittington
Senior Policy Advisor, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

Purpose of Report

1. This report responds to a request from Ministers for further information on the number of individuals who would be likely to pay tax on capital gains and on the distributional impact of taxing capital gains. The Minister of Revenue requested other information from officials which we have provided in a separate report (IR2019/031, T2018/175 refer).

2. The distributional analysis is based on the proposed design of an extension of the taxation of capital gains by the majority of the Tax Working Group. We will update the analysis following design decisions by the Government.

3. The information in this paper summarises previous information provided to the Tax Working Group in the Secretariat papers on *Distributional analysis* and *Distributional analysis and incidence*. These are attached. This report also provides new analysis including:

    - Further breakdowns of the estimated impact of taxing capital gains across net worth deciles (Figures 5-7)

    - The proportion of residential assets held by each household net worth decile compared with non-residential assets potentially subject to an extended taxation of capital gains (Figure 8)

4. Some of this new analysis has been prepared relatively quickly and should be considered preliminary. In addition, there is limited data in New Zealand on the distribution of wealth and what assets the wealth is comprised. Many of the estimates are approximations based on survey sample data and therefore subject to significant uncertainty[1].

5. We intend to discuss this report further with your office to determine whether there is further information we can provide that could assist you in decision-making, including in relation to distributional analysis of potential packages for Budget 2019. We will also be available to discuss further with you, if required at our meeting scheduled for 13 February 2019 on the Government's response to the Tax Working Group.

How many people are likely to pay tax on capital gains every year?

6. Estimating the total number of people likely to be affected by an extension of the taxation of capital gains in New Zealand is difficult to determine due to data limitations.

7. In addition, substantial capital gains are likely to be earned through trusts, companies or managed funds. These entities can be owned by multiple individuals and so a capital gain earned by one entity can represent tax on multiple individuals. For example, taxing capital gains in New Zealand is likely to impact most New Zealanders with a KiwiSaver account. There are 2.9 million New Zealanders who have KiwiSaver accounts and it is difficult to estimate how many of these people would be impacted by taxing capital gains and by how much they would be impacted.

International evidence on likely number of individuals who would need to pay

8. International experience can provide some insight on the distributional impacts of taxing capital gains. International experience suggests that only a small number of individuals pay capital gains tax *directly* (i.e. the tax is paid by the individual rather than by an entity on behalf of the individual) in a given year. For example in:

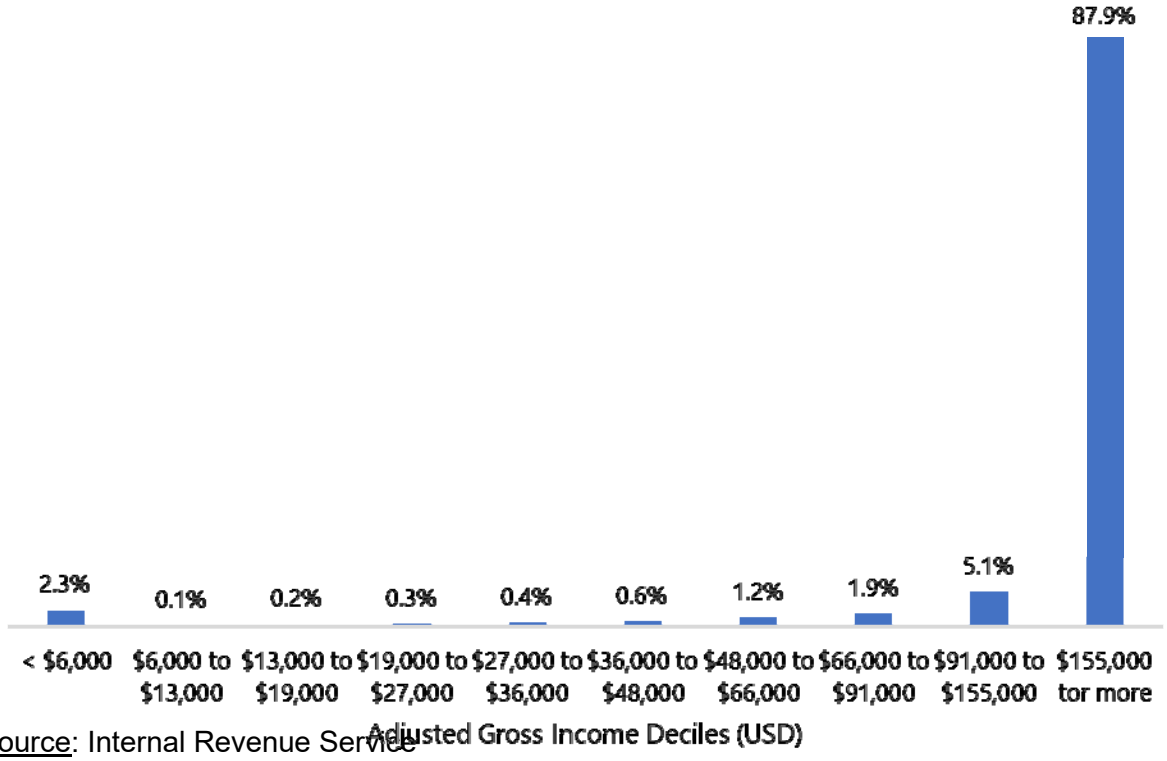
    - *Australia:* 4.7% of individual income tax returns included capital gains in 2015.

[1] Total estimated assets in these surveys do not exactly match estimates from aggregate data which is likely due to under-coverage of high-wealth households or under-reporting of assets in survey responses.

- *United States:* 7.8% of individual income tax returns included a taxable net gain from the sale of a capital asset, and 2.9% included a distribution of a capital gain from an entity (for example a trust distributing the proceeds of the sale of an asset) in 2015.
- *United Kingdom:* 0.8% of individual taxpayers had a capital gains tax liability in 2016/17.

9. The majority of these gains are paid by those with higher incomes. Figure 1 shows that in the United States close to 88% of capital gains are attributable to those in the top income decile.

Figure 1: United States income tax returns: percentage of capital gains by income band (2015)



Source: Internal Revenue Service

Note: This includes only those with a taxable net capital gain and excludes losses.

10. However, some of this progressivity arises from the fact that realised capital gains are lumpy. The size of the gains can push taxpayers into higher income brackets during the year when an asset is sold.

11. There is some international evidence to illustrate the size of this effect. In Australia, for example, taxpayer's in the top taxable income decile reported 70% of taxable capital gains. However, when looking at the distribution of gains by taxable incomes *before capital gains*, then only 40% of capital gains are earned by the top 10 percent of income earners[2]. This method of excluding capital gains will however, understate the progressivity of taxing capital gains. This is because excluding capital gains entirely removes a substantial proportion of these taxpayers total income.

What is the likely distributional impact of taxing capital gains in New Zealand?

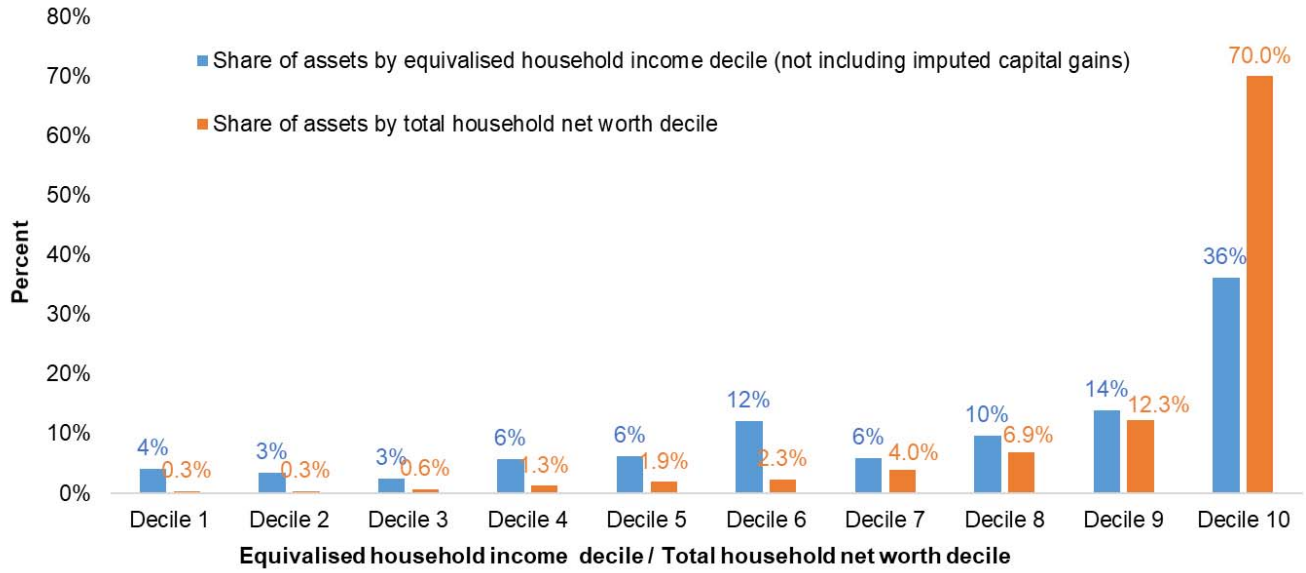
Wealth and income progressivity

[2] Based on work from Daley and Wood.

12. The progressivity of a taxing capital gains can be measured by income or wealth. Usually we define progressivity in terms of income, however one of the potential effects of taxing capital gains is reducing wealth inequality and so the charts below primarily focus on the distribution by wealth[3].

13. Most assets that are potentially subject to a tax on capital gains are held by high income and high wealth households.

Figure 2: Ownership of assets by equivalised household income decile (excluding capital gains) and total household net worth decile (Figure 5.1 in Final Report)



Source: Statistics NZ (HES 2015); the Treasury.

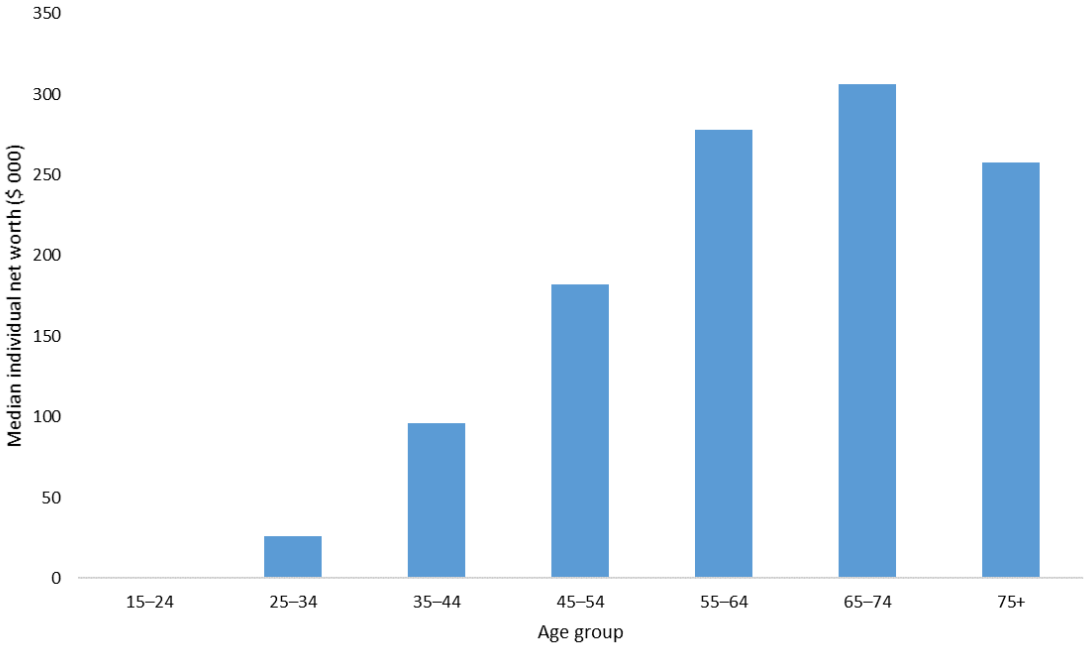
Note: this chart shows the distribution of household assets, excluding cash, deposits and owner-occupied housing by household income and net worth decile. This is used as a proxy to indicate the potential distributional impact of capital gains taxation (the data used to construct the income deciles however, does not include income from capital gains).

Wealth and age

14. Some of the skewed distribution of wealth is attributable to households having different amounts of wealth through their lifetime. Figure 3 shows that younger individuals generally have less wealth than older individuals.

3 In addition, estimating the impact of taxing more capital gains by incomes is difficult because income measurements in the data exclude capital gains. Once capital gains are included, many households in lower income deciles would need to be "re-ranked" and placed into higher income deciles. Without this re-ranking the impact of taxing capital gains on lower-income households will be overstated. However, this "re-ranking" is generally not feasible within the data.

Figure 3: Median individual net worth by age group (2015)



Source: Statistics NZ (HES 2015); the Treasury

15. The analysis below considers the legal incidence of a taxing capital gains (who would legally be required to pay the tax on capital gains). The economic incidence of taxing capital gains can be different (where the cost of a tax can be borne by others, for example through higher rents).

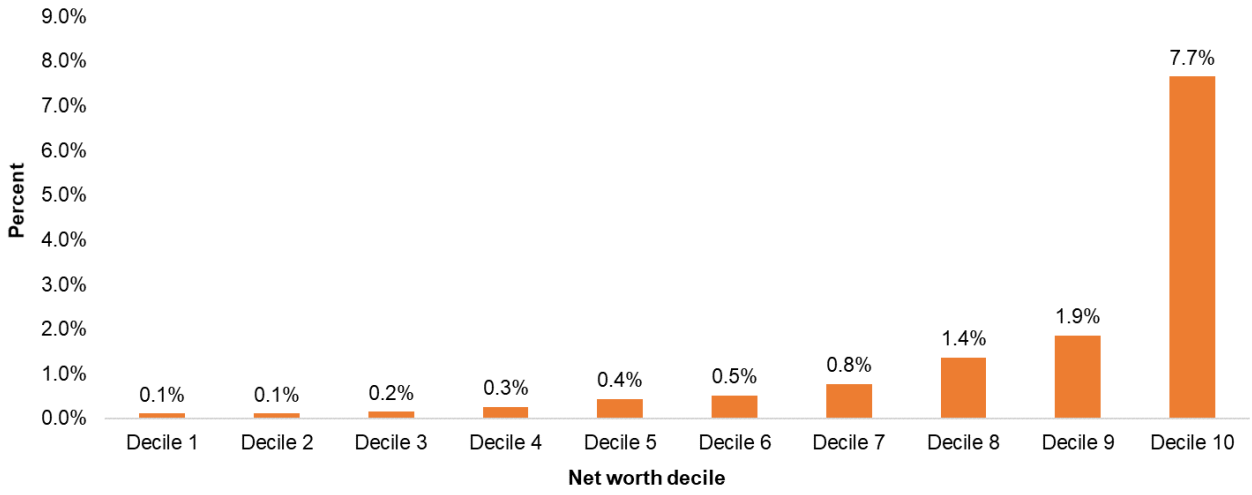
Distributional impact of extending the taxation of capital gains

16. Taxing capital gains is likely to be progressive. In particular, it is likely to be paid mostly by those with high wealth.

17. Figure 4 shows the estimated distributional impact of taxing capital gains for each net worth decile in New Zealand. This estimate is based on attributing the projected revenue from taxing capital gains to households based on their ownership of assets. It assumes all revenue from taxing capital gains (including tax paid by companies and trusts) is attributable to the owner.

18. Figure 4 shows the estimated capital gains liability as a percentage of *disposable* (i.e. after-tax) income. This effectively estimates how much of households' after tax income (excluding capital gains) will be required to pay the capital gains liability. However, this shows the average annual tax liability and will not show the actual cashflow impact for households associated with a realisation based tax which is expected to be lumpy.

Figure 4: Estimated annual average capital gains liability as percentage of disposable income by net worth decile



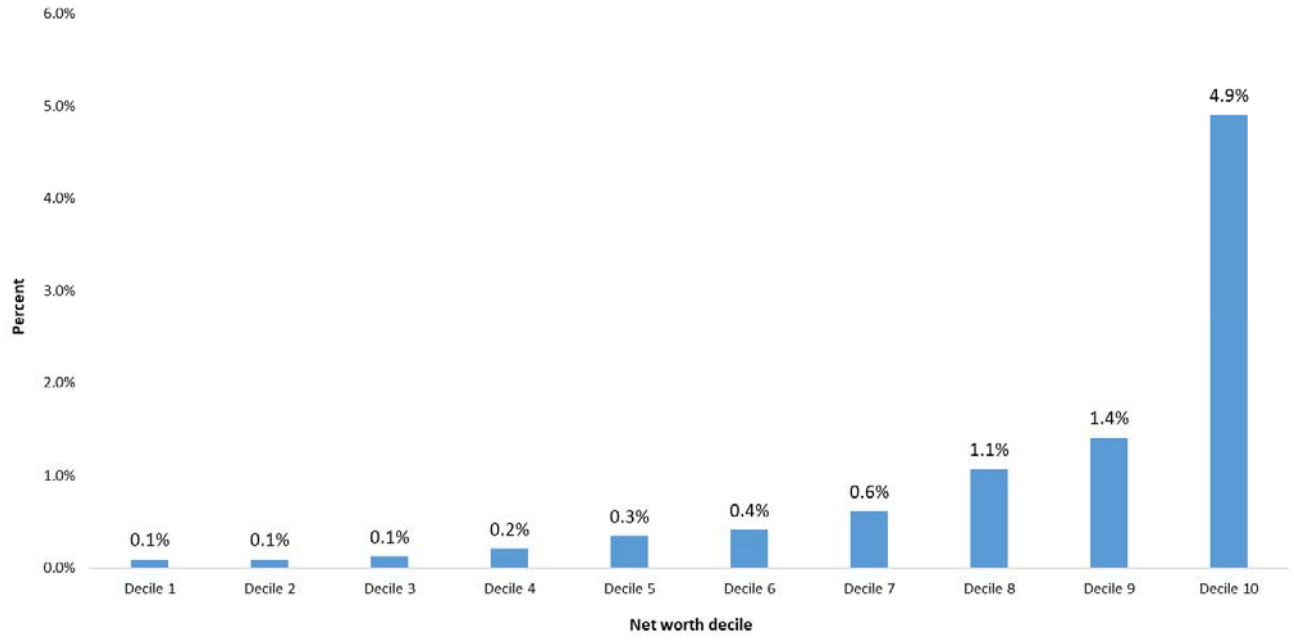
Source: Statistics NZ (HES 2015); the Treasury

Note: These estimates are based on the share of total household net worth that could be subject to capital gains taxation by household net worth decile, and projected revenue from the taxation of capital gains. Estimates for revenue from capital gains taxation are for the fifth year after introduction, discounted to tax year 2021/22 (when the tax is proposed to come into effect). Estimates are preliminary and indicative.

These estimates do not attribute the impact of taxing capital gains earned by managed funds to individual investors. However, the impact of this is likely to be small as managed funds hold only a small proportion of their assets in domestic shares and the Group did not recommend applying a capital gains tax to most foreign shares held by managed funds.

19. Figure 5 shows the estimated capital gains liability as a proportion of household's *total gross income including imputed capital gains.* This shows how much of a household's gross income (including capital gains) will be required to pay their estimated capital gains liability.

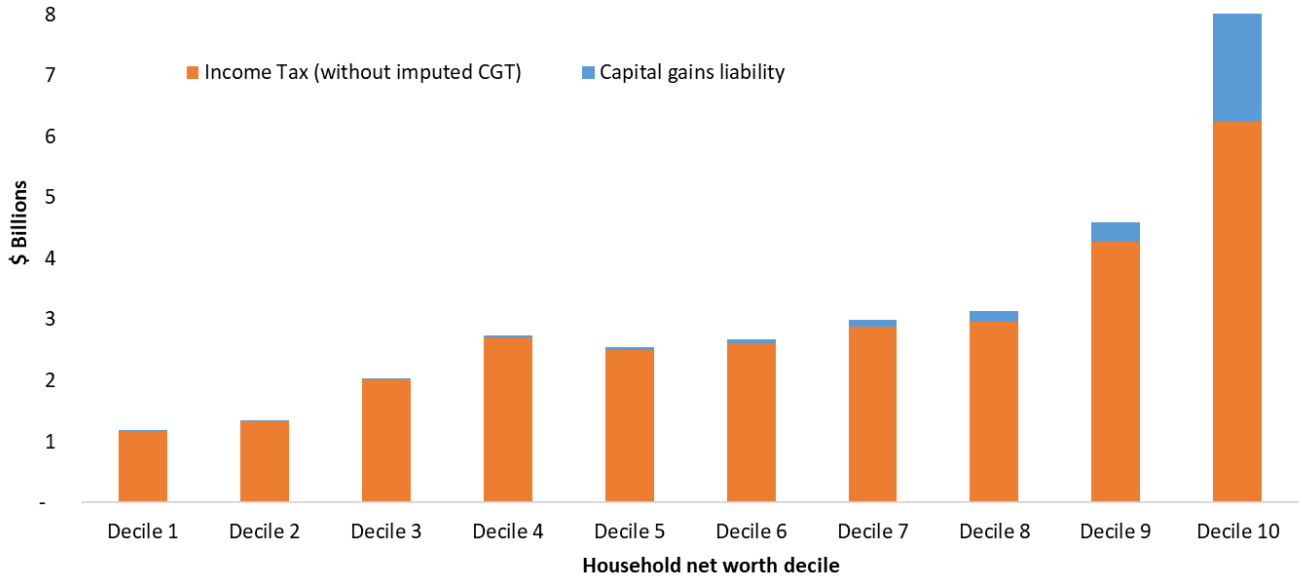
Figure 5: Estimated capital gains liability as a proportion of household's total gross income including imputed capital gains



Note: The calculation of total gross income includes taxable income as well as non-taxable transfers and other non-taxable private income. Calculation of gross income is net of the ACC levy but not income tax.

20. Figure 6 shows the estimated increase in overall increase in tax liability in absolute dollar terms from taxing more capital gains by household net worth decile. The estimated average increased tax for households in decile 1 is $50 per annum or a 0.7% increase in their tax liability (this is based on estimated capital gains in 2025/26 discounted to 2021/22) while the estimated increase in tax for households in decile 10 is $10,800 which is a 29% increase in their tax liability.

Figure 6: Personal income tax and estimated CGT liability by net worth decile



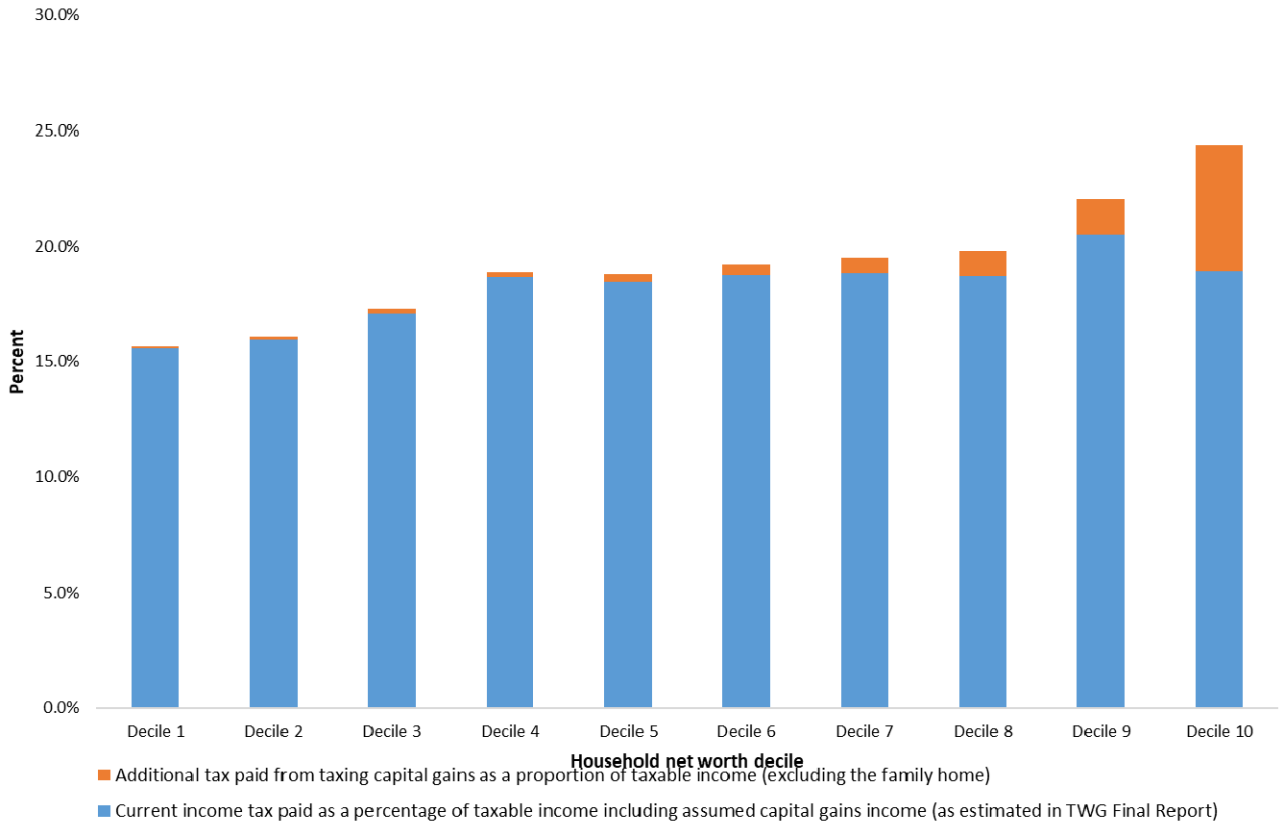
Source: Statistics NZ (HES 2015); the Treasury

Note: Estimates for revenue from taxing capital gains are for the fifth year after introduction, discounted to tax year 2021/22 (when the tax is proposed to come into effect). Estimates are preliminary and indicative.

21. Figure 7 shows the estimated impact of taxing capital gains on the average effective tax rate for households in each wealth decile. The grey line shows an estimate of the current average effective income tax rate on household's income when untaxed capital gains are included in their income. The blue line shows an estimate of their effective tax rate when these untaxed capital gains are taxed. The effective tax rate for those in decile 10 increases from 19% to 24% as a result of the taxation of capital gains.

22. As Figure 7 shows, when capital gains are untaxed, households in the top net worth decile are estimated have a lower effective income tax rate than those in decile 9. This is because those in decile 10 have a greater amount of untaxed income from capital gains. However, this actual distributional impact of taxing capital gains is subject to considerable uncertainty and Figure 7 is an estimate based on the modelling assumptions used (including an assumption of 3% annual price increases).

Figure 7: Average effective income tax rates by household net worth decile



Source: Statistics NZ (HES 2015); the Treasury

Notes: Capital gains: The estimates for capital gain used in this analysis are from the Tax Working Group Final Report. The share of capital gains tax liability by household net worth decile is based on the share of assets (excluding cash, deposits and owner occupied housing) by household net worth decile. Capital gains tax revenue estimates have been discounted to tax year 2021/22 (assuming 3 percent annual capital gain, and taxed at an average marginal tax rate of 26 %). Revenue from taxing more capital gains will be low in the first 4 years after implementation. For this reason, revenue from taxing more capital gain is discounted from year 5, or tax year 2025/26. The imputed capital gains excludes gains that would be subject to rollover relief.

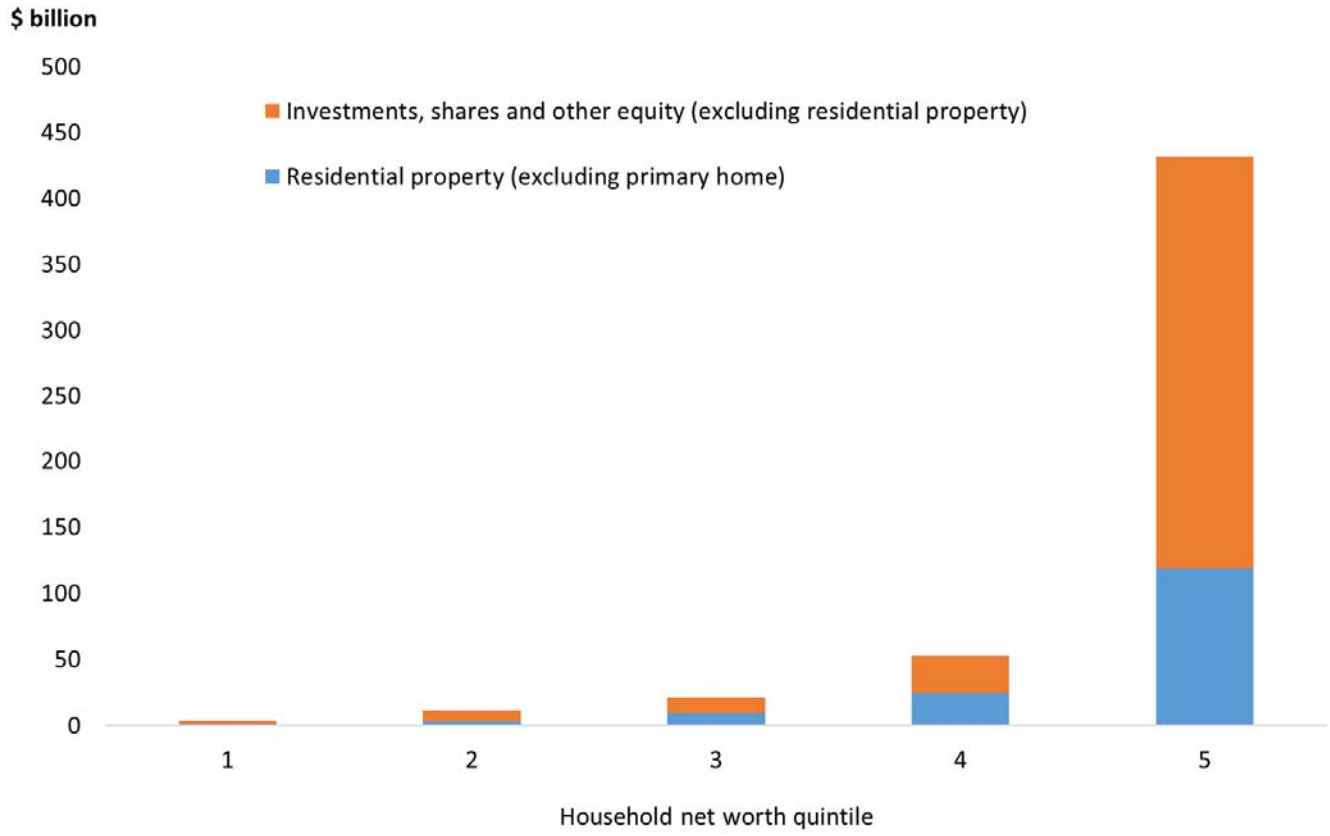
Data: Although the taxation of capital gains is envisaged to take effect after tax year 2021/22, the corresponding data on personal income tax by household net worth decile is not available for this period. The data for household economic survey used is for 2014/15. While Stats NZ released Household Economic Survey 2018 (for tax year 2017/18) in December 2018, the underlying data is not yet available for the purpose of this analysis.

Distributional impact of minority recommendation

23. A minority of the Tax Working Group recommended extending the taxation of capital gains solely to residential investment property. This is likely to be less progressive than a broad-based extension of the taxation of capital gains.

24. Figure 8 below shows that taxing residential property and other investment assets are both likely to be progressive with regards to wealth. However, non-residential investments are more concentrated among the wealthiest household quintile, so taxing these assets is expected to be more progressive than taxing residential investment property only. The wealthiest quintile own 86% of non-residential investments and 75% of residential property (excluding the primary home).

Figure 8: Selected assets by household net worth quintile



Source: Statistics NZ (HES 2015); the Treasury, Inland Revenue[4]

25. Figure 9 shows how much of each asset type is owned by each household net worth quintile. It shows that the ownership of assets potentially subject to an extension of the taxation of capital gains are skewed towards the highest net worth quintile.

[4] There are some limitations to this data. As outlined earlier there is uncertainty in the estimates due to lack of available information. In addition, some of the financial assets will be debt securities and other assets which are already comprehensively taxed. However, we expect the majority of the financial assets will be shares and equity in businesses. In addition, the attribution of assets from trusts and businesses to individuals is imprecise.

Figure 9: Percentage of assets owned by each household net worth quintile[5]

	1	2	3	4	5
Investments, shares and other equity (excluding residential property)	0.7%	2.3%	3.2%	7.7%	86.2%
Residential property (excluding primary home)	0.8%	2.1%	6.1%	15.8%	75.2%
Primary home	0.9%	5.6%	17.9%	28.1%	47.5%
Currency and other assets	3.1%	10.2%	15.1%	21.9%	49.7%

Source: Statistics NZ (HES 2015); the Treasury, Inland Revenue[6]

26. Figure 10 shows the composition of each household's asset portfolio by net worth decile. Figure 10 shows that the highest net worth decile invest a greater proportion of their wealth into non-residential assets than other net worth deciles.

Figure 10: Percentage of household assets for each household net worth quintile

	1	2	3	4	5
Investments, shares and other equity (excluding residential property)	16.3%	13.7%	8.5%	12.2%	41.1%
Residential property (excluding primary home)	8.0%	5.4%	7.1%	10.8%	15.6%
Primary home	26.3%	40.6%	57.6%	53.8%	27.4%
Currency and other assets	47.6%	39.6%	26.2%	22.5%	15.4%

Source: Statistics NZ (HES 2015); the Treasury, Inland Revenue[7]

How would taxing capital gains affect particular industries?

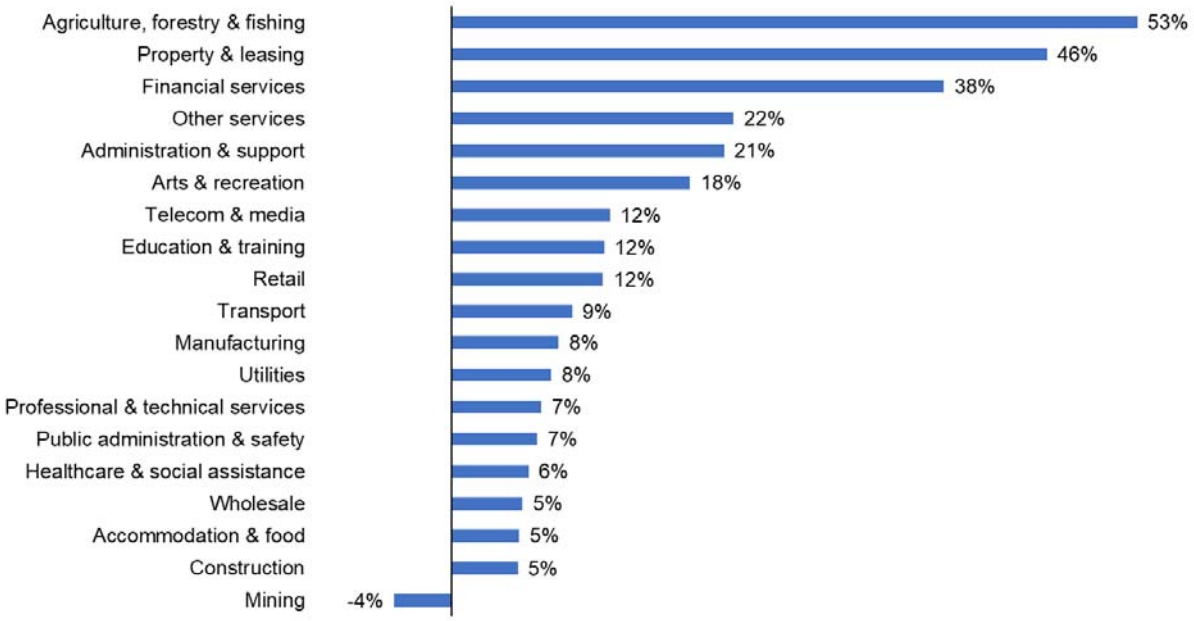
27. An extension of the taxation of capital gains is likely to have an uneven impact across industries. Figure 11 shows the untaxed realised gains as a proportion of the total accounting profit for different industries. This shows that capital gains make a significant part of the accounting income for the property, agricultural and finance sector.

5 Numbers do not add to 1 due to rounding and imprecision in some of the adjustments made.

6 There are some limitations to this data. As outlined earlier there is uncertainty in the estimates due to lack of available information. In addition, some of the financial assets will be debt securities and other assets which are already comprehensively taxed. However, we expect the majority of the financial assets will be shares and equity in businesses. In addition, the attribution of assets from trusts and businesses to individuals is imprecise.

7 There are some limitations to this data. As outlined earlier there is uncertainty in the estimates due to lack of available information. In addition, some of the financial assets will be debt securities and other assets which are already comprehensively taxed. However, we expect the majority of the financial assets will be shares and equity in businesses. In addition, the attribution of assets from trusts and businesses to individuals is imprecise.

Figure 11: Untaxed realised gains as a proportion of total accounting profit by industry (2013-2017)



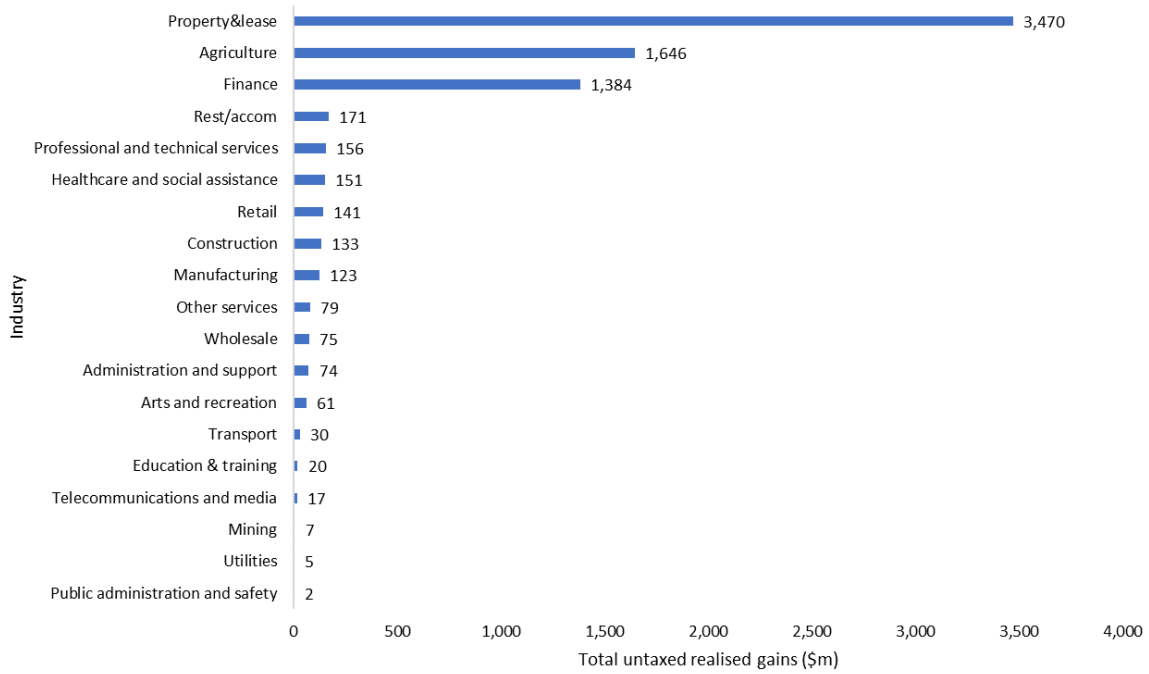
Source: Inland Revenue (IR 10)

Note: Figures 11 and 12 should be considered as an indicative view of capital gains earned by small and medium enterprises in New Zealand excluding a significant proportion of residential property owners. This is because the data used for these figures does not include most large businesses and a significant number of those in the residential property industry.

The finance industry in these charts is generally made up of "holding companies". These are closely-held companies holding investment assets for their owners.

28. Figure 12 shows the total amount of untaxed realised gains in 2017 for each of these industries.

Figure 12: Total untaxed realised gains by industry (2017)



Source: Inland Revenue (IR 10)