POLICY AND STRATEGY

Tax Policy Report: Options for extension of tax on capital gains

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Action sought

	Action sought	Deadline
Minister of Finance	**Note** the contents of this report	25 February 2019
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22 February 2019

Minister of Finance
Minister of Revenue

Options for extension of tax on capital gains

Executive summary

Purpose

1. Officials earlier reported on the pros and cons of the Tax Working Group minority view (taxing gains on residential rental property and second homes only) and the majority view (a comprehensive extension of taxing capital gains on all business and investment property) (*Major Design Issues in the Taxation of Capital Gains* (IR 2019/061, T2019/246). This report provides advice on another partial extension, of taxing the sale of land used in business as well as residential property. Like the residential-only extension, this extension would apply to capital gains from the sale of buildings and other improvements, as well as the unimproved land on which they sit.

Background

2. The earlier report concluded that:

   - A broad extension of tax on capital gains as recommended by the TWG majority, coupled with complementary changes to improve efficiency and productivity, would advance the Government's objectives for the tax system more than the narrower extension to non-owner occupied residential property recommended by the minority (paragraph 8)

   - An extension limited to all non-owner occupied residential property would nevertheless be an improvement over the current system (paragraph 9) and technically feasible (paragraph 81), as well as being the most feasible first phase if a phased-in implementation were desirable (paragraph 15). The Report also provided a table comparing the effect of such an extension with the effect of a broad extension

   - An extension to all non-owner occupied land and buildings (that is, the extension considered in more detail in this report) would be more problematic technically and have increased compliance costs (paragraph 81). It might also be difficult to implement in a reasonable timeframe.

Extension to all land

3. An extension of tax to capital gains on all non-owner occupied land is estimated to raise $4.3 billion over 5 years, as opposed to $2.3 billion for all non-owner occupied residential land. This is a static costing and does not take into account any behavioural impacts that could occur for example through people deferring the tax by investing in land through land-owning companies.[1] It is unusual internationally to tax capital gains on land without having a wider tax on gains on business and investment assets.[2]

[1] This report discusses the need to have taxation of the sale of land-rich companies, but even if the regime had this, there would still be cases of companies owning land that do not meet the definition. These could be sold without any tax impost, and might therefore be a preferred vehicle for land investment.

[2] We are aware of only two countries that do this, Cyprus and Malaysia.

4. From a practical and design perspective, an extension to all land raises some significant additional issues to those raised by an extension only to residential land. In particular it:

    - imposes tax on one class of business asset and not others, which is not horizontally equitable. Farmers and Maori collectives, who are heavily invested in land would be very much affected, whereas digital services companies (for example) would be unaffected

    - expands considerably the range of transactions where tax will have to be determined on an asset valuation basis (rather than simply by reference to the amount paid in an arm's length transaction). Any sale of a land-owning business is likely to require an allocation of the global price between land (taxable) and goodwill (generally exempt). This will be an on-going issue, which would not usually arise if tax is imposed only on a sale of residential property (except for the one-off requirement for valuations on valuation day)

    - creates a need to consider the possible introduction of roll-overs or concessions into the law, for example where business land is sold and replacement land acquired by a small business. These are the same kind of roll-overs that would also be considered in the case of a comprehensive extension

    - expands the range of transactions where tax may have to be imposed on a sale of shares in a land rich company. A rule to tax the sale of shares in land rich companies has the potential to cause considerable complexity This is true whether the extension is limited to residential land or applies to all land, but will be much less widespread in a more limited extension. There are a number of choices in the design of such a rule, and these are considered in some detail in this Report. Land rich company rules would not be required in the case of a comprehensive extension (except for non-resident owners of companies holding New Zealand land)

    - may be a higher compliance cost first step in a phased approach (than a residential only first step) because it will require businesses to undertake valuations on two valuation dates – first for business land, and later for all other business capital assets.

5. Maori own significant amounts of land collectively, such as Maori freehold land and through post-settlement governance entities. Officials will report to you in early March 2019 on how either a comprehensive or "all land" extension would apply to Maori collectively-owned assets, informed by an inter-agency process

6. Other partial extensions are technically feasible. For example, taxing listed shares is possible without much additional complexity, but if it does not include taxing unlisted shares, that would impose a tax penalty for listing which could adversely impact how companies and investors raise capital and the efficiency of capital markets.

Summary

7. The following table summarises the features and differences of the different extension options. More information is provided in the table in the main section.

	Residential land only	All land	Comprehensive
Revenue over 5 years	$2.3 billion	$4.3 billion	$8.2 billion
Types of businesses and taxpayers affected	Residential property investors and owners of baches and other second homes	As for residential land plus non-residential land investors plus all land owning businesses	Most taxpayers who own business or investment assets.
Complexity	Much smaller increase in compliance costs Less need for roll-overs. Increases compliance costs for residential landlords or landlords plus those with second homes. Valuations of existing assets less complex than other business assets and private shares Defining residential land rich companies, and taxing gains/losses, complex	Increases compliance costs for any taxpayer with land or shares in a land rich company Valuation issues less complex than for comprehensive but more complex than for residential only Defining land rich companies, and taxing gains/losses complex Increased pressure for roll overs.	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 Most pressure for roll overs No need to define land rich companies, except for purpose of taxing non-resident shareholders.
Efficiency and productivity	Least (minimal effects on efficiency and productivity)	Limited negative effects on efficiency and productivity (but greater potential for efficiency enhancing offsets)	More negative effects on efficiency and productivity (but greatest potential for efficiency improving offsets)
Integrity	Little effect on integrity outside of labour component of rental residential housing appreciation. Will replace existing bright line rule, thus eliminating the boundary between land held for shorter and longer periods. Need for rules for residential land rich companies, which will be complex and will create boundary issues	Will improve taxation of labour component of all land appreciation (eg farms as well as residential housing) Will replace existing complex rules taxing some sales of land. Need for rules for land-rich companies, which will be complex and will create boundary issues.	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

8. Having considered the issues further, officials are more comfortable with the possibility of an extension to all non-owner occupied land than previously, but:

   - do not consider it to be as effective a comprehensive extension in advancing the Government's objectives (particularly integrity), though this depends in part on how the revenue raised is used;

   - do not believe it is preferable to a residential only extension if the intention is a phased approach to a comprehensive extension.

Next steps

9. As previously signalled, officials plan on providing you in the week commencing 25 February with a report highlighting areas of capital gains design details where we are likely to recommend either:

   - the Government consult on an alternative approach to that suggested by the TWG majority view; or
   - where we are likely to suggest a slight variation to a TWG recommendation.

   This report will be for information purposes, similar to the recent report we provided on the "non-capital gains" recommendations of the Group.

10. There are some issues that officials are still considering in further detail, primarily the approach to Maori collectively-owned assets and the possible tax treatment of shares held in offshore companies. These issues will be covered in reports scheduled for early March.

11. Given the Government commitment to make announcements in April (and the extended recess over Easter and ANZAC day in late April), we consider that decisions on the form and content of any public consultation will need to be made by Ministers in mid-March so that a Cabinet paper can be drafted and considered by coalition partners.

Recommended action

We recommend that you discuss the contents of this report with officials, with the aim of deciding which option should be progressed by mid-March.

Noted | Noted

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Hon Grant Robertson
Minister of Finance
/ /2019

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Options for extension of tax on capital gains

Purpose

1. This Report follows a meeting between Ministers and officials in which you expressed interest in an option of taxing all property gains other than on owner-occupied property. This report discusses economic and technical design issues with that approach.

2. Ministers are invited to indicate what further information they require, in order to determine what proposal the Government wishes to consult on. This decision will be critical to [the content of the Government discussion document on the extension of tax on capital gains, which needs to be released by the end of May in order to meet the Government's intention to have legislation on capital gains enacted before the 2020 election.

Summary table

3. In our previous report, we included a table comparing the majority and minority recommendations. The following table supplements that by also summarising the all-land option analysed in this report.

Table 1: Comparison of comprehensive versus limited extensions of capital gains

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Revenue over 5 years[4]	$8.2 billion	$2.3 billion[5]	$4.3 billion
Impact on packages	• Provides significant funds for balancing initiatives in package; • Could fund productivity measures and/or fairness measures • If impact on business is a key concern, $4.0 to $5.3 billion for fairness measures after business package.	• If impact on business is a key concern, less need for business package (although business package desirable on own account) • Funds could be directed at fairness measures	• If impact on business is a key concern, greater need for business package. • 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	• Larger progressivity benefit than residential land only, but still much smaller than comprehensive

[4] These revenue estimates are 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.

[5] Of which about $0.4 billion comes from taxing second homes.

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
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	• Larger improvement than just taxing residential land. • Harsher treatment of land than business goodwill and other appreciating capital assets. • Under-taxation of non-land assets remains.
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, taxing gains on unimproved value of land is a relatively efficient (non-distorting) source of revenue • Taxing gains on improvements increases neutrality of investment while increasing taxes on investment • 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	• As for taxation of residential land generally in respect of gains in the unimproved value of land • Taxing gains on improvements will increase neutrality while increasing taxes on investment • Increases lock-in effect for land held by businesses.

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
Sustainability	• Broadening tax base and reducing 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	• Broadens revenue base more than residential only • 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	• Little effect on integrity outside of labour component of rental residential housing appreciation. • Will replace existing bright line rule, thus eliminating the boundary between land held for shorter and longer periods. • Need for rules for residential land rich companies, which will be complex and will create boundary issues	• Will improve taxation of labour component of all land appreciation (eg farms as well as residential housing) • Will replace existing complex rules taxing some sales of land. • Need for rules for land-rich companies, which will be complex and will create boundary issues. •

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
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 • Most pressure for roll-overs • Definition of a land rich company only applicable where shareholder is a non-resident.	• Much smaller increase in compliance costs • Less pressure for roll-overs. • Increases compliance costs for residential landlords or landlords plus those with second homes. • Valuations of existing assets less complex than other business assets and private shares • Defining residential land rich companies, and taxing gains/losses, complex • Either complex adjustments required for basis of shares in residential land rich companies, or valuations of shares they hold when significant share parcels are sold	• Increases compliance costs for any taxpayer with land or shares in a land rich company • Valuation issues less complex than for comprehensive but more complex than for residential only • Defining land rich companies, and taxing gains/losses complex • Either complex adjustments required for basis of shares in all land rich companies, or valuations of land they hold when significant share parcels are sold • Increased pressure for roll overs.
Coherence	• More coherent due to more comprehensive definition of income	• Leaves incoherence of not taxing a portion of income	• As for residential property extension.

Objective	Broad base	Residential rental or residential rental plus second homes only	All land
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 of houses may occur	• Less effect on housing than just taxing residential property, since less substitution of investment to non-residential land.

Economic considerations

4. The TWG minority recommended extending the taxation of capital gains to non-owner occupied residential real property (one member recommended excluding second homes) on the basis that there is evidence of consistent appreciation and of income from this asset being undertaxed. As set out in paragraph 35 of our previous Report, other forms of land also seem to appreciate consistently in value. The Corelogic data is repeated here for convenience. The data is for the unimproved value 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%

5. Taxing all gains in land (which includes improvements such as buildings) is an intermediate option between the comprehensive tax suggested by the Tax Working Group majority, and the minority opinion regarding residential rental land.

6. Taxing all gains on land would not be expected to cause large reallocations of resources in the economy for the simple reason that land is in fixed supply. Because of its fixed supply, taxing land tends to be regarded as a relatively efficient tax, as behaviour is distorted less (or not at all) in response to the tax. However, realisation-based taxes do affect the timing of realisations (i.e. there is a lock-in effect that prevents sales of land that would otherwise occur) which has an economic cost. Taxing gains on improvements will tend to increase neutrality (as most other returns on investment are already taxed) but have some deterrent effect on investment.

7. As with taxing gains on residential property, taxing all gains on land would be doing little to increase integrity or sustainability. It would do less to increase progressivity and horizontal equity than a general tax on capital gains but more than a tax on residential property only. It would have intermediate effects on efficiency and productivity and on compliance costs. It is likely to create greater compliance costs than a tax on residential real property only because new boundaries would be created which will create additional administration, enforcement and compliance costs. At the same time the additional compliance costs are likely to be significantly smaller than for a general tax on capital gains. It would also raise an intermediate amount of revenue creating less scope than a general tax to meeting the Government's set of objectives but more than a tax on residential property only.

General comments on design/complexity issues

8. A tax on non-owner occupied residential land may appear to be relatively simple from a design perspective, particularly as such land is already taxable if sold within five years. However, compared to the status quo it will give rise to some complexity, particularly in the following areas:

- The need for valuations, if the tax is introduced on a valuation day rather than a grandfathered basis (valuation is recommended by both the TWG and officials);
- Increased pressure for roll-overs in relation to land transferred by way of gift and inheritance;
- The need for rules to tax sales of land rich companies, in order to ensure the integrity of the tax. This is possibly the most complex of the three issues, and is considered in more detail below.

9. A tax on capital gains from all land (rather than only residential land) will increase the pressure and complexity in all of these areas.

    - The number of valuations required on valuation day, and their complexity, will increase. Extending the tax to all land will also put significantly greater pressure on property valuations on an on-going basis, since it will often be the case that non-residential land is sold together with business goodwill, creating a need to apportion the global purchase price between the taxable land and the non-taxable goodwill
    - There will be increased pressure for roll-overs or concessions, for example in relation to:
        - "like kind exchanges", where a small business sells one piece of land and replaces it with another;
        - retirement concessions.
    - The potential application of the land rich company rules will expand.

10. This report now considers these three issues in turn, on the assumption of an extension of taxation to capital gains on all land.

Valuation of land in business sales

11. Extending the tax to all land only will require tax to be paid on a value established by reference to valuation when land is:

    - held on valuation day, in which case the valuation will establish the cost base of the land. The need for valuation day values has been reported on already. A benefit of taxing only land is that it will eliminate the need to value business goodwill;
    - sold along with other assets, eg plant and equipment or trading stock. In this case a valuation will be necessary to establish the portion of the sale price that should be allocated to the land in order to determine the seller's taxable income and buyer's cost basis. This is already the case in most business sales, where the vendor is taxable on the amount allocated to trading stock and depreciable property (up to original cost) but not on other items, such as goodwill and (currently) most land. The global price should be allocated in accordance with market values. However, by allocating more of a global price to non-taxable assets such as goodwill, the vendor can reduce its tax liability. It is difficult for Inland Revenue to challenge allocations, in part because valuation is not a precise science.

12. So long as the vendor and purchaser are required to use the same values, in most cases this will impose a natural brake on the vendor's ability to over-allocate a global price to non-taxable assets. The purchaser will be reluctant to agree to an over-allocation because it will reduce the purchaser's tax deductions. Currently, the requirement for consistency is not as clear as it should be, and this should be addressed in the case of a land-only extension. Some protection can also be

provided by requiring the use of registered valuers for larger transactions, and providing safe harbour methods and non-binding guidance.

13. Provided adequate resources are available to provide some level of Inland Revenue scrutiny, officials believe valuation issues should be manageable. However there is still an increase in compliance cost and complexity compared to the residential property only proposal.

Increased pressure for roll-overs

14. Taxing all land may lead to increased pressure for roll-overs, as compared to taxing only residential land. An obvious example is where a business sells its existing premises and acquires new ones. The argument is made that taxing this kind of transaction discourages economically efficient transactions. That is true, but allowing roll-over relief (where there is no tax on the gain on sale but the tax basis of the replacement asset is deemed to be the tax basis of the original asset) simply defers the problem, and creates design complexity and increased compliance costs.

15. The following table compares the cases for roll-over under a comprehensive or land-restricted extension.

Comparison of other technical issues raised by comprehensive versus limited extensions of capital gains tax			
Technical issue (references are to TWG Final Report Vol.II)	**Comprehensive**	**Residential land only**	**All land**
Roll-overs for corporate re-organisations (chapter 3 para 21)	TWG recommends roll-overs for • Switching between trading structures • Transfers within a wholly owned group • Qualifying amalgamations • De-mergers • Scrip for scrip exchange	May be able to be omitted or simplified, given that assets are not business assets	Probably require the same suite of roll-overs as the policy objective of not wanting to discourage efficient business restructures still applies.
Small business roll-over (chapter 3 paras 28-30)	TWG recommends roll-over for gains on sale of qualifying business assets by small businesses if proceeds reinvested.	Recommendation not applicable	Recommendation will need to be considered.
Small business retirement exemption/concessions (chapter 3 para 32)	TWG recommends concessional rate for first $500,000 of capital gain by retiring long-term business owner	Recommendation not applicable	Recommendation will need to be considered.

Land rich companies

16. Potentially the most complex design issue is how to deal with land held in companies. For example, suppose a natural person, or a company, holds land

acquired for either investment purposes or use in the person's own business, through a special purpose company. Suppose then that the person wants to sell the land, or the entire business, and that the land has increased in value. If there is a tax on sale of the land, but there is no tax on the sale of the shares, selling the shares is an obvious way to avoid the imposition of the tax. This is not an issue in a comprehensive extension of tax on capital gain, where share sales are taxed.

17. If the sale of shares in land-owning companies is not taxed, at least in some circumstances:

- that will encourage those investing in land to do so through companies, which will distort economic activity. For example, passive investors wanting to invest in land will be encouraged to do so through listed or unlisted property companies rather than direct ownership or via a partnership.
- companies and individuals will be encouraged to hold land in special purpose companies which can be sold without incurring tax.

Possible solutions

18. Possible solutions to this issue are as follows.

- do nothing and accept the potentially very significant loss of tax revenue that would result. This is the approach we already take in relation to most taxable land, trees and minerals, but those are all cases where the nature of the activity means an asset sale is inevitable in the short or medium term;
- tax sales of shares in companies, whether resident in New Zealand or elsewhere, which hold land, either entirely or partially, with or without exceptions. This will address the deferral and investment distortion issues, but creates other complexities.

Each of these solutions is considered further below.

Do nothing

19. As referred to above, gains and losses on some categories of land are already taxed in New Zealand, without there being any provisions to deal with the possibility of deferral using a company to hold the land. This does lead in practice to some element of deferral, for example in the forestry sector. However, the categories of land which are taxed are limited, and in many of them, the possibilities of deferral are, for various different reasons, also limited.

20. The only situation where sale of a land rich company is taxed is where the land is subject to the bright line rule. The bright-line rule is discussed in further detail in the Appendix.

21. In Malaysia and Cyprus, where land is generally the only asset subject to CGT, there are provisions to tax sales of shares in land rich companies. This is discussed in more detail below.

22. If gains on all sales of land become taxable, and there were no rules to tax shares in land rich companies, it seems inevitable that most land, particularly in a commercial context, would be held by special purpose companies, so that ownership of appreciated land could be transferred by sale of shares in a land-owning company without triggering the tax obligation. The tax would thus raise relatively little revenue, but would impose deadweight costs on the economy due to the complexity which ownership of land through separate companies would cause.

23. Doing nothing to deal with land owning companies would be a very significant weakness in a proposal to impose tax on gains from sales of land.

Tax sales of shares in land rich companies

24. The alternative to doing nothing is to tax sales of shares in land rich companies.

25. The purpose of a land rich company rule may be:

    - A broad "economic equivalent" purpose, which would justify taxing any sale of shares in a land rich company:
    - A more avoidance focussed purpose, which would limit the rule to taxing sales of shares which are substitutable for a sale of land. For example, such a rule would prevent people avoiding the tax by putting any land they own in a special purpose company, and selling the shares in the company rather than the land.

26. There is already an anti-avoidance rule of this nature in the bright-line tax, but if the tax on the sale of land (both residential and all-land) were to become more common, an explicit taxing rule would be needed.

27. There are a number of design issues that would be need to be considered:

- How much land must the company own to be considered "land-rich" (eg, 50%?),
- How much of the shares must the shareholder own or sell before being subject to tax? For example, 100%, 50%, 20%, any shares?
- How much of the gain should be taxed? All of the gain from selling the shares, or just the gain attributable to land?
- If there are other shareholders who do not sell, what are the consequences for them or the company?
- Whether to apply to companies that are land-rich but operate a business that is more complex than investing in land. Examples include electricity generation companies and retirement villages.
- How to apply to companies that invest in land on behalf of portfolio shareholders? Examples in include property trusts and property PIEs.

28. Working through these issues would require significant consultation. Further technical discussion of land-rich companies and some precedents are discussed in an appendix to this report.

APPENDIX: LAND RICH COMPANY ISSUES

Precedents

1. There are four precedents we are aware of for taxing land rich companies.

Tax treaties

2. While the relevant provisions differ, as a general proposition treaties allow (but do not require) a country to tax the sale of shares in a company that at any time in the 12 months before the sale derived more than 50% of its value from real property in the country (see Article 13(4) of the 2017 OECD Model Convention). The OECD Model Commentary mentions various possible amendments to this provision including:

   - changing the 50% threshold;
   - an exclusion for shares in listed companies;
   - an exclusion for property held in connection with an active business, eg a hotel or a mine;
   - limiting the provision to where the vendor holds more than a certain percentage of the company's shares.

3. The reason for the 12 month rule is to prevent shareholders escaping source country tax on their shares by injecting new assets into the company shortly before sale, thus diluting the percentage of the company's value made up by real property. The OECD Commentary recognises that where the decline in the percentage during the 12 months leading up to a sale is due to an actual sale of property by the company which has been taxed already, countries may limit the source country's right to tax the sale of the shares.

4. It is important to understand that land rich company treaty provisions do no more than create an exception to a general prohibition on source country taxation of capital gains. They do not have to deal with the problem of how to ensure such a tax works properly.

Bright line land rich company rule

5. The bright-line land rich company rule (section GB 52 of the Income Tax Act 2007) taxes a sale of shares in a company which owns land a sale of which would be subject to the bright-line, if:

   - the company's directly or indirectly owned assets consist 50% or more of residential land; and
   - 50% or more of the shares in the company are sold within a 12 month period with a purpose or effect of defeating the bright-line rule.

6. In this case, the selling shareholder is taxable on (broadly) the change in value of the bright-line property since it was acquired by the company up until the date of sale. This may be quite different from their actual gain or loss from selling the shares.

7. Officials do not know whether this rule has ever been applied. As drafted, it may not be sufficiently robust or detailed to deal with land rich companies where there is no time limit on revenue account status. For example, it is unlikely that a tax avoidance purpose requirement would be appropriate in that context, s9(2)(g)(i) s9(2)(g)(i) But it is a useful indication of a possible approach.

The Malaysian rule[8]

8. Malaysia does not have a general tax on capital gain, but does tax capital gains from sale of Malaysian real property. The rate starts at 30% but declines to either 5% or 0% after 5 years (0% for Malaysian individuals). To buttress this tax, it also taxes gains on sale of shares in a real property company (RPC). An RPC is a "controlled company" which at the time of sale holds Malaysian real property which it acquired at a time when such property made up at least 75% of the value of the company. A controlled company is one with less than 50 shareholders which is controlled by five or fewer shareholders. The tax rate is on the same sliding scale as it is for the tax on property. However, the time period applies to the period for which the person holds the shares. Unlike the New Zealand rule, the period for which the company has held the land does not seem to be relevant.

The Cyprus rule

9. Like Malaysia, Cyprus taxes gains on sale of real property (at 20%). To support this tax, it also taxes gain from sales of shares in unlisted companies which own Cyprus property directly, and from sales of shares deriving more than 50% of their value directly or indirectly from property in Cyprus. It appears that only the portion of the gain that relates to the change in value of the property is taxable (ie the same approach taken in the bright line land rich company rule). We have not been able to find any more detail on this rule.

Comment on precedents

10. These precedents illustrate some of the issues that would need to be considered in defining what a land rich company is, and in calculating the taxable gain on sale of shares in such a company. A more systematic examination of the issues follows.

Technical issues raised by the need to deal with land rich companies in an extension of taxation to all gains on sale of land

11. If the decision were made to tax gains from sale of land rich companies as part of an extension of tax to all land, the technical rules that will need to be considered fall broadly into the following categories.

    - Defining when a person's shares in a company are subject to tax on the basis that the company is land rich.
    - Determining how much gain to tax. This is not at all straightforward.
        - If the entire gain is taxed on sale of the shares is taxed, it raises the complex basis adjustment rules referred to in chapters 7 and 10 of the TWG Report, which are different depending on whether the shareholder is an individual or a company, and whether the land rich company is a member of a wholly owned group, an imputation group, a tax consolidated group, or not a member of a group at all.
        - If only the gain (or loss) attributable to the property is taxed, these adjustments may not be needed, but the portion of the gain or loss on sale of the shares that is attributable to property will need to be determined.
    - If the entire gain or loss on sale of shares is taxed, dealing with the transitional issues that arise when a person's shareholding becomes or ceases to be subject to the rules (in cases where that happens either after the person acquired the shares, or while they still hold the shares)

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[8] Malaysian information comes from https://realestate.bakermckenzie.com/tax/.

- Considering whether or not the various corporate roll-over reliefs (eg for share for share take-overs and demergers) should apply to transactions involving shares in land rich companies;
- Considering how the rules should apply to KiwiSaver and other managed investment entities holding shares in land rich companies (unless the definition of a land rich company means it is unlikely one would be held by such an entity)

There is a degree of interdependence between some of these issues.

12. Consideration will also need to be given to how any new rule will affect shares in companies whose land is already taxable outside of the brightline. There will also be miscellaneous consequential issues[9].

When should shares be subject to tax on the basis that the company is land rich

General discussion

13. There are two possible bases for a land rich company rule. Which basis is chosen will determine many of the features of the rule.

    - The rule may be trying to ensure that a person who is economically invested in land is taxed on a realisation of their investment.
    - The regime may be trying to ensure that a person cannot easily replace a sale of land with a sale of shares, for the purpose of avoiding tax on a gain on sale of the land.

14. The distinction can be illustrated by considering some simple scenarios.

    - Listed property companies. These are common investment vehicles. Their assets will usually be nothing but land (which they lease to other businesses) and associated assets. Economically, ownership of shares in such a company is very much equivalent to owning land directly and employing a manager, except for the fact that pooling of investments allows access to much more expensive buildings. If a land rich company rule is intended to capture gains on sales of interests in land, then such a company would be land rich. However, a person who sells their shares in such a company does not have a choice of instead selling land, and is not doing so as a way of avoiding tax on such a sale. If the focus of a land rich rule is on the issue of substituting sales of land with sales of land owning companies, the listed property company is not land rich.
    - A subsidiary of a listed property company. If the listed property company itself sells land, the sale will obviously be taxable. If the listed property company holds land through a special purpose subsidiary, should a sale of that subsidiary also be taxable? Arguably the subsidiary provides useful non-tax benefits, such as limited liability and possibly a useful focus for management and financial reporting. However, those benefits are only relevant while the listed property company (indirectly) owns the land. They do not require that a sale of the land occur by way of sale of the subsidiary. Accordingly, such a subsidiary company should be land rich.
    - A portfolio of rental properties, owned ultimately by a single family or family trust, held in a holding company structure with each property owned by a separate subsidiary. For similar reasons to those considered immediately above, both the subsidiaries and holding company should be land rich.

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[9] Such as the need to adjust available subscribed capital in the affected companies by the amount of the gain or loss

- An operating company, owned by an individual or family trust, which owns its own premises. Under current law, sales of businesses are in fact done by way of sale of shares or assets, for reasons that usually include but are not limited to the different tax treatment of the transaction. Imposition of tax on sales of land will undoubtedly encourage such a sale to be done by way of shares if the land has appreciated (and by way of assets if it has not), but it will not change the nature of the choice. This might suggest that in most cases, such a company should not be defined as land rich. However, if land is fundamental to the business (which may be determined by reference to the proportion of the value of the assets made up by land), the importance of the different tax treatment may be sufficiently significant that the company should be defined as land rich. An obvious example is a company which owns a farm. Depending on where the threshold is set, it might also include a company owning a relatively unsuccessful business operating from inner city land. Possible value thresholds are 50% (as in the model tax treaty) or 75%. It may be useful to consult on what sort of companies would be captured by these thresholds. These would need to be supported by anti-stuffing rules.

15. Moving on from these simple scenarios, the third and fourth scenarios can be modified by supposing that there are two, or three, or twenty five, unrelated investors. The connection between them may be relatively close (eg there may be a detailed shareholders or incorporated joint venture agreement) or more distant. The greater the number of shareholders, the less substitutability there is between selling shares and selling land.

16. The second issue that needs to be considered in this section is whether the rule should only apply to a shareholding of more than a certain size, eg 10%. An argument in favour of such a minimum is that a sale of a portfolio interest in a land owning company is quite different from a sale of an interest in the land itself. However, if the shareholder is selling their shares along with a large number of other shareholders (eg in the context of a take-over offer pursuant to drag-along tag-along rights) it might seem arbitrary to tax some shareholders and not others.

Straw man

17. As a straw man for discussion, a possible definition could be based on the CFC definition, which defines when income earned by a foreign company may be attributed to New Zealand shareholders. On this basis, a company would be a land rich company if it is owned as to 50% or more by five or fewer investors (counting associated persons as a single investor) and either 50% or 75% or more of its value is made up of real property. Valuation could be based on the most recent set of consolidated accounts of the company, possibly adjusted for any major or non-ordinary course transactions.

18. It may be appropriate to amend this test so that it is met only if 50% or more of the company is owned by a smaller number of investors, eg two or three. As a practical matter, the problematic use of land rich companies will most commonly arise where land is owned by one or two investors (again, treating associates as a single investor).

19. At least in some contexts, it may be tempting for shareholders to assume their company is not land rich, rather than making enquiry at the time of sale. It might be appropriate for companies who are not clearly excluded from being land rich (as listed companies might be, for example) to be under an explicit obligation to provide such information to shareholders, since the company is in the best position to know the facts.

How much should be taxed?

20. As referred to above, there are two approaches to this issue.

- Put land rich holding company shares on revenue account (the "taxable shares approach"). This appears to be the approach taken by Malaysia.

- Attribute to the selling shareholder their share of the change in value of the land held directly or indirectly by the company (the "land attribution approach"). This is the approach taken in the bright line land rich company rule, and apparently by Cyprus.

Revenue account approach

21. The taxable shares approach is considerably technically more complex than the land attribution approach. It requires

    - complex share basis adjustment rules
    - property basis adjustment rules to prevent double deduction of losses
    - rules to deal with situations where a company becomes or ceases to be land rich.

    Example

    Suppose a family trust holds a portfolio of investment properties through a single holding company, which in turn owns each property through a subsidiary. Suppose the trust wants to sell a property, which has increased in value from \$1m to \$2m during the trust's period of ownership. If the subsidiary sells the property, it will have a taxable gain of \$1m. If the parent sells the subsidiary for a gain, assuming the subsidiary is land rich, that gain will also be taxable. However, the gain on sale of the shares in the subsidiary can be quite different from its gain from sale of the property. Suppose for example that immediately prior to sale of the shares, the subsidiary borrows \$1m from its parent, and uses the funds to pay the parent a dividend, which would be tax exempt. This will reduce the value of the shares by \$1m. Prima facie, a sale of the shares in the subsidiary will therefore give rise to \$1m less profit than if the dividend had not been paid.

22. Rules that prevent this kind of tax planning are referred to in the TWG Interim and Final Reports. They are amongst the most complex of the rules required by a comprehensive tax on capital gains. The third set of rules, dealing with transitional situations, have not been considered to date. Officials' preliminary view is that they will also be very complex.

23. If these rules are not enacted on a fully considered basis, tax planning structures can be used which not only eliminate tax on economic gains, but create tax losses in the absence of real ones. This is illustrated by New Zealand's experience with putting petroleum mining companies on revenue account – a rule that was abandoned in 2002 when tax planning using holding companies led to multiple deductions being claimed for a single economic loss.

Land attribution approach

24. The land attribution approach avoids most of these difficulties in adjusting the basis of shares and dealing with transitional situations. However, it means that any time a person sells shares in a land rich company, they (or more likely the company) will need to determine the accrued gain or loss on all land held directly or indirectly by the company. This will require not only valuations, but a level of co-ordination between the company and the shareholder.

25. In the example set out above, the sale of shares in the subsidiary would be a taxable event for the parent, but the amount of income would always be \$1m, being the movement in the value of the property. The subsidiary's cost base in the property would increase to \$2m.

26. For the land rich rule to apply in the first place, the value of the property owned directly and indirectly by the company will need to have been determined. The additional factor that will need to be considered in order to determine the shareholder's taxable gain or loss (which may be larger or smaller than their actual gain or loss) is the tax cost of the property. It may be possible to rely on the most recent balance sheet and tax returns of the company, at least in some cases, and to put the company (which will be in possession of the relevant facts) under an obligation to provide this information to the shareholder. The company will need the information in order to adjust its cost base in the property.

27. An issue with this approach is that where only part of a company is sold, the increase in the tax basis of the land will create a benefit for all shareholders (by way of reducing the amount of gain when they sell their shares), not just the purchasing shareholder. This may significantly discourage or complicate such sales.

28. The technical and practical challenges of either a taxable share approach or an attribution approach are considerable