



Inland Revenue
Te Tari Taake

POLICY AND STRATEGY



THE TREASURY

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Tax policy report: Further advice on potential asset coverage

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Security level:	Sensitive - Budget	Report number:	[IR2019/111] [T2019/563]

Action sought

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

Contact for telephone discussion (if required)

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4 March 2019

Minister of Finance
Minister of Revenue

Further advice on potential asset coverage

Executive summary

1. The economic and social consequences of the taxation of more capital gains depend on what asset classes are included in the tax. You asked for advice regarding two possible sets of asset coverage:
 - a tax that exempts the taxation of capital gains on corporate assets; and
 - a tax that is only levied on residential rental property (excluding second homes).
2. This report first outlines the consequences of exempting the capital gain on corporate assets from any extension of the taxation of capital gains. This proposal does not appear to match with the Government's broader economic and social objectives and has anomalous consequences.
3. It has been suggested by s9(2)(a) that an exemption of the taxation of capital gains on corporate assets could be implemented in the following ways:
 - For listed companies, capital gains earned by the company would not be taxed, but shareholders selling shares in listed companies would be taxed on any gain (this would only apply to resident shareholders).
 - For widely-held unlisted companies (more than 25 shareholders, none owning more than 50%), the same rule would apply as for listed shares except no gain on the sale of shares by shareholders would be taxed unless the shares were acquired after the effective date of the tax (grandparenting).
 - For private/unlisted companies, any gain earned by the company would be attributed to the shareholders and they would have to pay tax on the gain. For the shareholders, they would pay tax on the gain from the sale of shares only if they acquired the shares after the effective date (grandparenting).
4. This approach has been suggested as a solution to three potential issues:
 - **Goodwill valuation:** The difficulty of valuing of business assets, specifically goodwill.
 - **Compliance costs:** The high compliance costs associated with necessary rules for corporates.
 - **Double-taxation and equity market effects:** The potential for double taxation of shareholders, exacerbating instead of solving the differential tax treatment of assets.
5. In our view, the approach is unlikely to be effective in addressing these issues and may create other negative unintended consequences:
 - Such an exemption will do little to deal with the goodwill valuation problem and will only have a limited effect on the double-taxation problem.

- In terms of the reduction in compliance costs, the greater incentive to tax plan to avoid capital gains tax will partially undercut this benefit and may give business an incentive to incorporate in order to take advantage of this tax benefit.
 - The method to address tax planning (deeming sales to occur at a shareholder level for closely held companies) would in effect treat small businesses more harshly than large businesses.
6. Insofar as this exemption will include grandparenting of existing assets at valuation day, and leaves the capital gain of non-residents untaxed, it will reduce government revenues and create an unfairness in how the burden of the taxation of more capital gains is shared.
 7. The report also outlines the consequences of exempting second homes from a tax on the capital gains on residential property.
 8. Exempting second homes does reduce compliance costs and lowers taxation on those who own a vacant second home (eg a bach). However, it also creates compliance and administrative costs associated with the definition of a second home, leads to tax avoidance opportunities to investors in residential property, and may be seen as unfair relative to the treatment of capital gain income from other assets. Such an exclusion will likely restrict the supply of rental property and increase the rents faced by low-income households.
 9. Overall, we would recommend against both exclusions. The TWG approach to taxing both corporate and shareholder capital gains is appropriate and fair given that adjustments are made to compensate for double-taxation. The exclusion of second homes from any tax on residential property risks undermining the governments housing related and may be perceived as an unfair concession to those with existing housing wealth.

Recommended action

We recommend that you:

10. **note** the contents of this report.

Noted

s9(2)(k)

Mark Vink
Manager,
Tax Strategy, the Treasury

Noted

s9(2)(k)

Matt Benge
Chief Economist
Policy and Strategy, Inland Revenue

Hon Grant Robertson
Minister of Finance
/ /2019

Hon Stuart Nash
Minister of Revenue
/ /2019

An exclusion of corporate capital gains from taxation

11. New Zealand's company tax system includes imputation credits for corporate tax paid. This implies that the company tax acts as a withholding tax for shareholders that are New Zealand residents, and a final tax for shareholders that are non-resident. In the absence of company taxation non-resident shareholders would be largely untaxed, and there would be an incentive for domestic residents to accumulate income in companies in order to defer paying tax.
12. For a domestic resident, the New Zealand tax system attempts to tax the individual at the same rate irrespective of their income source. In this way, the income tax base for companies is the same as for individuals.
13. Given this equal treatment of income, and the importance of a withholding corporate tax to limit deferral opportunities, the Tax Working Group (TWG) suggested taxing capital gains at both the shareholder and corporate level – with the corporate taxation of capital gains acting as a withholding tax through the imputation system.
14. Furthermore, the taxation of capital gains at both the shareholder and corporate level is in line with how capital gains are taxed in other countries.
15. Four potential issues with taxing both corporate and shareholder income have been raised: the valuation of goodwill, the compliance and administrative cost, the potential for double taxation, and equity market effects.
 - **Goodwill valuation:** Some business assets, specifically goodwill, will be difficult and expensive to value on valuation day.
 - **Compliance costs:** The cost of compliance for corporates may be high relative to revenue, especially given necessary rules around double deductions, mergers and demergers, and forms of rollover (eg scrip-for-scrip).
 - **Double-taxation:** When shareholders sell shares for a gain in a company with unrealised gains that will be taxed later, or when companies retain earnings, then the tax liability is imposed on existing shareholders as well as the company.
 - **Equity market effects:** The introduction of taxation of more capital gains is intended to place assets allocation on a more even playing field. If there is significant double-taxation of corporate investment in New Zealand, then this could lead to a bias against investment in the corporate sector.
16. The introduction of a comprehensive capital gains tax will have **compliance costs**, however whether those costs rise or fall given an exclusion depends on the design. Exclusions encourage tax planning for individuals and business who have the ability to reclassify income. Insofar as more complex rules around enforcement and reporting of income are required to reduce this tax planning this can increase compliance costs. However, removing the need for companies to value assets will reduce compliance costs.
17. In the case of an exclusion of corporate assets, the compliance cost benefits associated with not having to report realised capital gain income will also come with the broader efficiency cost associated with encouraging incorporation of businesses that would – without the tax incentive – be better served by staying unincorporated.
18. It is likely that the **revenue sacrificed** from such an exclusion would be significant. According to data from the Australian Tax Office, in the 2015/16 year companies paid 36% of the tax on capital gains in Australia. Although this exaggerates the long-term revenue loss from such an exclusion – as for domestic residents the tax would eventually be paid at the personal level – this does suggest that there would

be a sizable deferral benefit for companies which reduces the value of tax received by the government. However, to the extent listed companies earning capital gains are owned by non-residents, the foregone revenue will never be recovered.

19. The **equity market effects** problem was raised in the context of **double-taxation**, and the concern that the double-tax issue would disincentivise investing in equity rather than investing in other assets. As a result, both issues are considered together. Data shows that the double-taxation issue is generally not a problem for listed companies, as they regularly distribute imputation credits which shows they are regularly distributing taxed income. For private companies, they can manage their affairs to avoid double tax before the sale of a company. For corporate groups, share cost adjustment rules are being considered to manage double tax (and double loss) issues.
20. The majority of the TWG and the Secretariat were of the view that further special rules (other than those referred to in the paragraph immediately above) were not required to address the double-taxation of unrealised capital gains.
21. However, another solution that was raised by one member of the Tax Working Group ^{s9(2)(a)} is to only tax capital gains at the shareholder level (on distributions and gains on the sale of shares). ^{s9(2)(a)}; paper sketching out this solution is attached in Appendix 1 in this report. The Secretariat's initial response to this recommendation is given in Appendix 2.
22. This solution leads to different income tax bases for individuals and corporates and as a result such a solution also requires that the scope of the exclusion is set appropriately (eg including gains to residential rentals held by companies).
23. Such a solution does not solve the problems identified and can create additional issues in the tax system. In order to evaluate this, it is necessary to consider how the exemption of corporate taxation of capital gains would work for both listed and unlisted companies, and for widely and closely-held companies.

Widely-held listed companies

24. For widely-held listed companies it has been suggested that no tax on gains at the company level should be levied, with a tax on distribution to shareholders (including capital gains) and on gains on the sale of shares.
25. An initial valuation of the company on valuation day is provided by the value of shares. As a result, the value of the goodwill of a listed company will be reflected in its share value which will be known on valuation day. Given this the **goodwill valuation** concern is relatively unimportant for listed companies.
26. Exempting capital gains at the corporate level addresses the part of the **double-tax** issue associated with unrealised corporate capital gains.¹ However, this would still double-tax retained earnings.
27. Widely-held companies would benefit (in general) from lower **compliance costs** due to the exclusion of corporate assets from the tax base.
28. Although the benefits from excluding listed companies are small, there are also costs. Non-residents and those with tax exempt status do not pay tax on the capital gain associated with their shares, and as a result would not pay any tax on capital gains. This can be compared with the system proposed by the majority of the TWG, where gains are taxed at the corporate level. Under that system, foreign

¹ That is, from the share price appreciating because the company has assets that have appreciated in value that have not been sold.

shareholders will bear some of the cost of the tax when they hold shares in companies that realise capital gains.

Widely-held unlisted companies

29. The same method of tax (no tax at the company level) has been suggested for widely-held unlisted companies. This will lead to similar effects on **double-taxation** to the situation with a widely-held listed company.
30. The complicating factor is that unlisted companies do not have an initial share price on valuation day to determine company value.
31. Exempting the taxation of corporate capital gains on widely-held unlisted companies does not remove the need to have an initial **valuation of goodwill** to determine the tax liability when a share in the company is sold. As a solution to this problem, Robin Oliver's paper suggests shares in these companies are grandparented.
32. However, the costs associated with grandparenting (limiting the application of the tax to assets acquired after the date of introduction) were already identified as more significant than any valuation issues in the TWG report. In the context of this proposal these issues are:
 - **Lock-in:** Grandparenting makes individuals reluctant to sell shares in companies they owned prior to the introduction of the tax, even when there are economically prudent reasons for the sale.
 - **Compliance and administrative costs:** Although the asset no longer needs to be valued on the day the tax is introduced, it creates issues regarding when an asset enters the tax base – which require administration to prevent avoidance and additional collection and reporting of information by asset owners. For example, if a company starts to undertake new business and so the company value reflects assets invested in after the introduction of the tax, at what point should their shares no longer be grandparented?
 - **Lost revenue:** The combination of lock-in and higher compliance and administrative costs reduce the revenue received from the tax. Australia introduced a capital gains tax in 1985 with grandparenting for existing assets, and there are still assets that have not yet been taxed.
 - **Unfairness:** Grandparenting involves taxing two people who are making the same investment decision (to sell a given asset) differently based on the day they purchased the asset.
33. As a result, the goodwill problem is only solved if grandparenting is introduced for shares. This comes with the associated costs of grandparenting, which are likely to be substantially larger than the costs associated with the initial valuation of goodwill.

Closely-held unlisted companies

34. Closely-held companies are companies with few large shareholders such that the ownership and management of the company are performed by the same person. In this case if a company is not taxed on a gain but shareholders are, then a company's owner can hold their personal financial assets in a company and defer the payment of any realised capital gain.
35. As a result, high wealth individuals could use a closely-held company to defer capital gains tax payments on their personal assets, introducing a significant unfairness into the tax system.

36. The solution suggested in ^{s9(2)(a)} paper for this issue is to force closely-held companies to distribute any realised capital gains in the year they were realised. In essence this involves treating assets as though they were held directly by shareholders.
37. Although this removes the incentive to hold personal assets in a closely-held company, it also treats closely-held companies more harshly than other corporate entities. Due to this treatment, it results in no **compliance cost** benefits to this corporate entity.
38. As in the case of widely-held unlisted companies, the goodwill problem is only solved if grandparenting is introduced for shares with the associated costs.

Summary of the exclusion of corporate capital gains

39. An exclusion of the taxation of corporate capital gains has been suggested on the basis that it will reduce the compliance cost of the taxation of capital gains, remove the problem of finding an initial valuation of goodwill, and prevent double taxation.
40. However, such an exclusion comes with a number of issues:
 - It will reduce compliance costs for corporates, but at the cost of lower government revenue.
 - It will only remove the issue of valuing goodwill insofar as grandparenting of goodwill is introduced, which comes with revenue and fairness costs.
 - It will remove the double-taxation of unrealised gains but not realised earnings. As companies currently manage their affairs to avoid temporary double-taxation, the actual benefit of limit double-taxation appears limited.
41. Overall, the full proposal for excluding corporate capital gains from the income tax base does not appear to satisfy government objectives in terms of the fairness of the tax system.

Excluding the second home from a tax on residential property capital gains

42. Taxing only the gains on residential property (excluding owner-occupied property), instead of a more comprehensive scheme is subject to the same efficiency and fairness trade-off associated with any general exclusion:
 - It is less equitable as it treats income sources differently and redistributes less from those with high wealth than those with low wealth.
 - It is potentially inefficient if it biases land use away from rental property for tax reasons.
 - It involves sacrificing revenue. Taxing only residential property would raise \$2.3bn in the five years to 2025/26 compared to the \$8.3bn raised from a comprehensive scheme.
 - It reduces compliance and administrative costs by removing the need for owners of other assets to furnish tax returns. At the same time, it does risk creating compliance and administrative costs due to the need to create a boundary between residential property and other asset classes.
43. Targeting a single asset class (eg residential property) where there are multiple uses for the land the asset is used on is likely to reduce the supply of that specific asset and put upward pressure on rents. In the case of residential property, rents in areas where rental property can be more easily substituted (eg for commercial

- or owner-occupied residential activity) will likely increase more when the capital gains tax falls only on residential rental property, rather than on all the potential uses of that land. The increase in residential rents has both a fairness cost (given that renters tend to have lower incomes) and an efficiency cost (as investment has been distorted away from providing appropriate housing services for tax reasons).
44. The view of the TWG, which we agree with, is that the rental pressure and associated efficiency costs from taxing only residential property would be limited. If second homes (eg baches) are also excluded then the size of some of these trade-offs will change as there is now an additional substitution – between holding a housing unit as a rental property or as vacant property.
 45. A motivation for excluding second homes is that they make up part of an individual or family's personal property, like their primary residence or jewellery. As personal property is excluded from the suggested extension to the taxation of capital gains there is an argument for considering an exclusion of second homes.
 46. The additional economic impact of an exclusion of second homes depends on how second homes are defined. There are a number of issues that would need to be worked through, for example:
 - If a residential property has ever been rented out, can it be defined as a second home?
 - If so, how long must it have been since it was rented out?
 - Does renting out to a family member make the property a second home or a rental property?
 - If a rental property is sold to a related party at a below market price, and that house is not rented out, is it now defined as either a owner-occupied or second home?
 47. **The exclusion of a second home will increase rents:** Once a second home is clearly defined, its tax-exempt status creates a tax incentive to hold property as second homes instead of as rental properties. As a result, depending on the definition the exclusion of second homes can lead to individuals keeping property off the rental market including, in some cases, removing tenants from existing rental properties and leaving them vacant. This would reduce the supply of rental property and increase rents.
 48. **Even without higher rents, such a concession may be perceived as unfair:** Individuals and families that have a second home for personal use own an asset that is generating income (capital gains) that are untaxed, while other individuals who own a similar asset (a rental property) are taxed on the same income gain.
 49. **The revenue cost could be material:** Current estimates suggest that forgone revenue from the exclusion of second homes would be \$360m in the five years to 2025/26, or around 16% of the revenue raised by an extension of the tax on capital gains to non-owner occupied residential property. This is without modelling any behavioural response.
 50. **Depending on the rules it will lead to tax planning and gaming of the system:** Excluding second homes from the income tax base will likely reduce compliance cost for those who own a second home. However, depending on the definition of the second home and the level of enforcement there is a risk that owners property owners where the boundary between a second home and a rental home is unclear will face additional compliance cost.
 51. Overall, there are significant negative fairness and efficiency consequences associated with excluding second homes from the income tax base. These concerns are exacerbated by the risk that a second home exclusion will lead to a reduction

in the supply of rental property, reducing the real disposable income of low-income households.

Summary

52. You asked us to evaluate the case for or against two exclusions from an extension of the tax on capital gains:
- excluding corporate capital gains from a comprehensive scheme; and
 - excluding second homes in addition to owner-occupied land from a tax on the gains from residential land.
53. Given the costs and benefits of these exclusions in terms of efficiency, compliance, and fairness, we recommend against these two exclusions to the income tax base following an extension of the tax on capital gains.

Appendix 1 – Taxing Share Gains but not Gains Made by Companies – s9(2)(a)
paper

54. This note considers some of the detail of an option of not taxing companies on capital gains but instead taxing such gains in the hands of non-corporate shareholders when the shareholders themselves realise the gains whether as a distribution from the company or as gain on the sale of shares. This can be seen as consistent with a broadly-based tax on capital gains but one limited to realisation on the basis that only individuals (and entities such as trustees taxed along the lines of individuals) are the real objective of taxation.
55. Company income is that of the individual shareholders and companies are taxed as in effect a withholding tax on the income earned for shareholders. When a company realises a gain but does not distribute that gain to shareholders and shareholders do not sell the shares, then it can be argued that although the company may have realised a gain the shareholders have not.
56. I note at the outset that a proposal along these lines would be a distinctively different approach than set out in the TWG Interim Report and relative to current law. In the time available this note sets out an outline of an approach – it has not been fully developed or analysed and it follows not consulted on. There is no international precedent as far as I am aware to base this approach on. The issue the option attempts to address
57. The option attempts to address three main issues raise in submissions on the broad extension of capital gains taxation as set out in the Interim Report.
- Concerns re transition as a result of the requirement to value property as at 1/4/21. These concerns are not limited to but focus on businesses and business assets and especially the somewhat nebulous and hard to value concept of “goodwill”.
 - Concerns regarding the high compliance costs especially regarding companies. The necessary anti-double deduction rules for corporates are seen as having very high compliance costs and in addition complex demerger, script for script and amalgamation rules seems (based on at least some Australian feedback) to result in relatively little tax collected but high costs.
 - Concerns regarding the potential adverse effects of the Interim Report proposals on New Zealand equity markets. This is a range of possible problems from inconsistency of tax treatment individuals and PIEs/KiwiSaver to the double taxation (tax penalty) when shareholders sell shares for a gain in a company with unrealised gains that will later be taxed.
58. What seems clear is that the Interim Report proposal will increase tax on New Zealanders owning shares in New Zealand companies (but not New Zealanders owning shares in foreign companies or foreigners owning shares in New Zealand companies). There has been strong evidence that residential rentals are under-taxed (in terms of reasonable commercial rates of return that are taxed). Some evidence that land in general is taxed (although the case for unfettered roll over for substitute assets seems strong given land prices tend to rise across the board and a person selling land to buy land is having to pay more for the new land and thus can reasonably seen as not realised). There is not much evidence it seems that equity overall is under-taxed at least excluding land rich companies. Put another way there seems to be evidence that under current rules there are tax-induced distortions to investment in land especially residential rentals but not otherwise.
59. This would suggest a more specific extension of capital gains taxation (to say residential rentals) but if there is a perceived need to adopt a more comprehensive

approach the approach outlined below could be explored further. Response -in general

60. Continue taxing companies only on revenue account gains (gains already taxable) with imputation but not otherwise. Then tax shareholders on what is distributed to them (dividends) and their gains on sale. In this way capital gains are taxed once – at the shareholder level when in effect they are realised by the shareholder. The government could still extend the scope of taxed gains – most obviously to residential rentals held by companies. It could also tax the gains on all depreciable assets and if it wanted land (although in my view land needs extensive substitute property roll over as above). The key issue is not to tax hard to value items such as goodwill. This response seems to work most easily with listed or public companies where management and ownership are separated and there is a reasonable market value for the shares for the transition.

Listed/Public companies

61. Could consider wider than just listed on stock exchange provided separation owner/manager, insider trading rules etc. apply and readily available market to value. As above:
- No tax on gains at company level (including share gains). So no tax on goodwill.
 - Tax at shareholder level on distributions (including capital gains) and gains on sale of shares.
62. Issue 1 dealt with (ready value can be given to shares). Issue 2 dealt with since no need for complex rules to handle double deductions etc. May still need de-merger rules. Re issue 3 – not taxing at shareholder and company level so no double taxation of unrealised gains in most cases (as now). My preference would be to go further and tax the shareholder under a fair return method at 3.5% (no option to use current value when share price falls). Imputation credits can be used to meet fair return tax. Then relatively simple rules and no under taxation.

Unlisted widely held companies

63. Basically companies that owners cannot treat the corporate assets as in essence their own. Have to take into account minority shareholders and no right to buy them out. Could be "widely held" (25 or more shareholders but that current definition excluded "closely held" which precludes companies where a person and associates hold 50% or more which can be many public companies. Same as listed:
- No tax on gains at company level (including share gains). So no tax on goodwill.
 - Tax at shareholder level on distributions (including capital gains) and gains on sale of shares.
64. But then have a problem of valuing the shares. If that is a problem grandparent existing shareholding. Do not in my view need continuity requirement or to deal with asset changes. When shares are sold gains are taxed (or lose grandparenting). I would have no roll over of grandparenting on death or gifting. No tax but new owner takes new value and is then taxed. Company may sell and buy assets (not taxed so in effect roll over relief) but shareholders cannot use this to hold their own property since minority shareholders involved. Problem of fair return method is valuation. Danger also of low value company (low FRR) but labour income – professionals in a company paying little FRR tax.

Other (closely held) companies

65. Issue here seems to be that owner and management can in effect be the same. This seems the most difficult issue to resolve. The problem seems to be that if a company is not taxed on a gain but the shareholder is, the shareholder can hold the property in a company and in effect access rollover relief. A person can put their property into a company. Sell the property (no tax) and repurchase other property or hold cash to invest with no tax. In effect roll over relief for substitute assets when no intention to provide such relief. An example would be holding shares in a company rather than personally. Sell shares for a gain and reinvest. I cannot see any other opportunities this creates but open to suggestions.
66. Could deal with this by requiring closely held companies to distribute the gains on the sale of "taxable property" to be distributed to shareholders in that year. Taxable property is property that is not taxable in the hands of the company but would be taxable if held by an individual but would also exclude CFC active income or interests in active CFCs (for the reasons given in the Interim Report) and that does not for roll over relief and is not grandparented. For this to work there seems to be a need to grandparent at least hard to value business assets such as "goodwill". This is intended to be a targeted anti-avoidance rule and so should be targeted where otherwise a company can be used to access what is in effect rollover relief when that is not the policy intent. It would thus seem appropriate to limit this to portfolio share interests, rental properties and specified other material property gains that need targeting.
67. The suggested approach seems more workable the more there is unrestricted roll over relief for in substitute property. If the policy intent is to have no or very limited in substitute roll over relief (the position it seems of the Working Group) it seems likely that this would result in a tax penalty for operating a business through a company. The requirement to distribute gains to shareholders could be met by an actual distribution (taxable) or a credit to current account – still taxable. Crediting to current accounts means cannot just allocate to the lowest rate taxpayer – the company has a legal debt to that shareholder. Shareholders can agree to turn current accounts into equity if so needed. Note that any gains so required to be distributed would have no imputation credits so company could not distribute taxed earnings in lieu of gains. Also in this case have issue with valuation of shares. If an issue may need to grandparent these shares. Grandparented shares will be taxed on distributions but not gains on sale of shares. Again no continuity requirement is necessary – some shares grandparented others not. Also no need for Australian rules re change in the nature of the asset – shares remain the same although could have
68. Rules that if rights attached to shares materially change (move from no right to distribution to right to distribution) then deemed sale and repurchase of shares. I have also considered LTC etc rules. These are more complex although a lot of the restrictions although much of this seems to be because sale of shares in LTC likely to be untaxed. Most of the issue is the look through treatment which means partnership approach requiring adjustment to the cost basis of all entity property for each owner.
69. In any case the above seems simpler and all that is required and by necessity the LTC rules are only elective. Having looked at this issue it does seem however that the LTC rules could be simplified if share gains are taxed. Assessment None of the above is perfect but it should be compared with the Interim Report which we all presumably agree has imperfections even if supported. Also this is just a cursory look at these issues. My overall assessment is that the problem area is trying to restrict in substitute property roll over relief for property held in closely held companies.

70. This suggests the approach would only be workable with less restrictive roll over relief than the Working Group is now considering. Underlying this approach is that gains should be taxed only when cash or a debt is derived by an individual shareholder. It is argued that this can be seen as consistent with a realisation capital gains tax. There seems to be an inherent contradiction if this approach is adopted but there is restricted in substitute roll over relief for individuals. That policy contradiction leads to the need for rules requiring company gains to be in effect deemed to be distributed to shareholders so we preserve cash realisation only by deeming a non-cash realisation to be a cash realisation which is sophistry.
71. With all these caveats the option does suggest a way of legislating the essence of a reasonably comprehensive taxation of capital gains, raising most of the expected revenue (residential land and shares) while minimising compliance costs and fiscal risks of bringing property into the tax base by way of hard to measure valuations and minimising what seems to be the main on-going compliance costs associated with overseas capital gains tax rules in the corporate area. This is by way of extensive substitute property roll over relief, taxing shareholders and not companies, and grandparenting shares that have no ready market valuation. It is no clear that the complexity justifies such a pragmatic approach but it would provide an option should Ministers need that.

Appendix 2 – Secretariat comment on the idea of exempting capital gains at the corporate level

Introduction

1. The idea of exempting capital gains at the corporate level has been raised as a potential solution to three issues with the Group's main proposal. Those three issues are:
 - It will be costly to come up with a valuation day value for assets like goodwill (**the goodwill valuation issue**)
 - Any rules to deal with double taxation and double deductions will be complicated and perhaps only partially successful (**the double tax issue**)
 - There will be increased taxation of New Zealand equity markets (**the taxing equity issue**)

Analysis

2. New Zealand's company tax system with imputation means the company tax operates largely as a withholding tax for shareholders that are New Zealand residents, and a final tax for shareholders that are non-resident. From a domestic perspective, taxing at the company level removes an artificial advantage (if the alternative is not taxing company income) to earning income through a company instead of individually. In the absence of company taxation there would be a strong incentive to accumulate income in companies and not pay dividends or sell shares so that there would be major tax deferral opportunities.
3. In order to prevent deferral, the income base for companies is the same as for individuals (except for some exceptions owing to the different legal nature of companies).
4. Exempting capital gains for companies while taxing them for individuals would be a major departure from this similar income base approach which prima facie should result in efficiency, fairness, and revenue costs. The justification for suggesting this seems to be that there are significant compliance costs relative to revenues, and that there are risks of double deductions and double taxation from applying capital gains tax at both the company level and the individual level. One particular concern has been whether much capital gains tax revenue will be received from corporate capital gains taxation. Evidence from Australia and other countries shows that companies pay a significant amount of capital gains tax, and officials have done significant analysis to recommend rules to minimise instances of double taxation and double deductions (and the Group is suggesting that the government consider the Australian consolidation approach, in case that would be better). Following are more detailed comments.
5. The exemption would require different rules for listed companies, and for closely and widely held unlisted companies, and so this note addresses both separately.

Widely held listed companies

6. Exempting capital gains at the corporate level addresses part of the **double tax issue**. This leaves taxation of capital gains at the shareholder level, through taxation of dividends and a new shareholder capital gains tax. This would still double tax any retained earnings (although the Secretariat notes that it does not consider this to be a major problem given that data on imputation credit balances suggests that most publicly-listed companies pay out imputation credits quickly).

7. As an initial point, it's worth noting that this proposal would not really address the **taxing equity issue**, except to the extent that it removes any **double tax issue**. Even if capital gains are exempt at the corporate level, investors in New Zealand equities will be taxed on their capital gains.
8. At times there will be difficulties in valuation, when listed companies have to determine a gain from selling a particular business. In the Secretariat's view, this **goodwill valuation issue** for publicly-listed companies is unlikely to be significant enough under the Group's current proposal to justify a departure from the underlying principles of the imputation system.

The value of the goodwill of the listed company itself will be reflected in its share value which will be known on valuation day. Goodwill is potentially relevant if a listed company sells an operating subsidiary (which will have its own goodwill component). Even so, in the experience of many countries, corporate reorganisation rollovers often mean it is not necessary to know the value of valuation day goodwill, depending on how the sale is structured.

9. The downside of exempting listed companies is unfairness from exempting the largest companies from the tax, and revenue loss as it is unlikely the listed company would pay out the income as an unimputed dividend (while listed companies have a high level of distributing imputed dividends, they are much less likely to distribute unimputed dividends), and many shareholders of the listed company would not pay tax when they sell their shares (because they are non-resident or tax exempt).

Widely held unlisted companies

10. Trying to extend the proposal to unlisted companies creates its own issues.
11. Exempting capital gains for widely held unlisted companies would not solve the **goodwill valuation issue** as those companies would still need a starting valuation including goodwill to measure capital gains if their shares are sold. If this is too difficult, then it has been suggested these shares might be grandparented. But that raises all the problems the Group has identified with grandparenting.

Closely held unlisted companies

12. Closely held companies have the same problems as above, but the additional problem that owner-managers will be able to defer the tax by not selling shares nor paying unimputed dividends. As a solution, there might be a requirement to distribute any realised capital gains in the year they were realised unless rollover treatment were available. In effect though, this means harsher treatment for closely held companies than listed companies, unless there is generous rollover. In effect, closely held companies are treated as though their assets were held directly by their shareholders, and hence not eligible for the proposed exemption from capital gains tax for companies. It also means there is no compliance cost/simplicity benefit for these companies if the capital gain income must be distributed because it means the capital gain income must still be calculated.

Summary and conclusion

13. In summary, the option would grandparent goodwill and unlisted shares, and either:
- Provide extensive rollover for closely held companies
 - Deem distributions of capital gains realised at the corporate level for closely held companies.
14. It would not completely resolve any double tax issues, and would still tax investors on their equity gains. In terms of goodwill valuation issues:
- (a) in the relatively limited circumstance of a sale by a listed group of a business line there should be no issue (no need to value goodwill because sale not taxable); and
- (b) in relation to a sale by a non-listed widely held group of a business, goodwill valuation issues would be resolved only if the shares in the holding company are grandparented.
15. In the secretariat's view, the option outlined is inferior to the main proposal developed by the Group. It would also reduce revenue (to the extent a company is owned by non-residents or tax-exempt shareholders, tax would not be paid even if a dividend is paid or the shareholder sells their shares) and raise equity and integrity concerns if companies are exempt from the tax while individuals must comply.

	Public companies	Widely held unlisted companies	Closely held companies
Goodwill valuation issue	Unlikely to be a major issue under current Group proposal	If it resolves, it only does so through grandparenting	If it resolves, it only does so through grandparenting
Double tax issue	Partially resolves (still have double tax of retained earnings)	Partially resolves (still have double tax of retained earnings)	Double tax n (manageable if closely held). Solves double deduction problem.
Taxing equity issue	Doesn't resolve	Doesn't resolve	Doesn't resolve
Other points	Likely to result in revenue loss	May require grandparenting of existing businesses	May require grandparenting of existing businesses