Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

THE TREASURY
Kaitohutohu Kaupapa Rawa

Tax policy report: Capital Gains and Labour Income

Date:	4 March 2019	**Priority:**	Medium
Security level:	Sensitive	**Report number:**	IR2019/116 T2019/558

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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Minister of Finance
Minister of Revenue

Capital Gains and Labour Income

Executive summary

This paper responds to the issue raised in public commentary of whether it makes sense to tax returns from entrepreneurship at the same rate as other income.

This is a noting report. We discuss, by way of examples, how taxing capital gains can reduce incentives for entrepreneurial effort but only to the same extent as an income tax reduces work incentives more generally. Attempting to tax gains as neutrally as possible is aimed at promoting fairness and efficiency by ensuring that all forms of income are taxed as even-handedly as possible. Concerns that taxing capital gains will reduce entrepreneurial effort or investment can be addressed by other neutrality-enhancing measures such as reinstating building depreciation and addressing loss carryforwards and blackhole expenditure.

Recommended action

We recommend that you **note** the contents of this report.

Noted

Noted

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Hon Grant Robertson
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/ /2019

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Purpose

1. Capital gains may at times be a reward for the labour effort or business acumen of the owners of a business. Also capital gains may reflect compensation to the owners of a business for taking on risk. The aim of this note is to explore, through illustrations, whether these considerations provide grounds for not taxing capital gains or for taxing capital gains at concessional rates in order not to discourage entrepreneurial effort.

Background

2. Some media commentators have raised the question of whether it makes sense to tax returns from entrepreneurship at the same rate as other income. This note provides advice on the issue.

Discussion

3. Under New Zealand's tax settings we attempt to tax a very broad definition of income as neutrally as possible. Generally employees are taxed on their salaries and wages when they are paid. These salaries and wages will reflect a reward for people undertaking jobs that may be more or less arduous and working in occupations which may be more or less risky.

4. If capital gains are not taxed, not only will some forms of capital income be untaxed, there will also be scope for certain forms of labour income to escape taxation. Both of these situations raise fairness and efficiency concerns.

Example 1 – Do-it-yourself improvements

5. Consider an individual who buys a house for $400,000, through their own efforts makes improvements to the house (e.g., repairs, recarpeting, painting) and who a short time later sells the house for $600,000. Much of any gain (over and above the cost of material used in making the improvements and transactions costs in buying and selling the property) will reflect compensation for the individual's efforts as well as profits from having the business acumen to see that this was a profitable opportunity. If this gain is not taxed, the treatment of labour income is not horizontally equitable and this provides incentives for people to undertake this sort of activity even when they would prefer to take a paid job in the absence of tax considerations. The fact that salaries and wages are taxed while capital gains are not provides a tax bias encouraging them to earn tax-free capital gains rather than undertaking paid employment where income is taxed. Here the absence of a tax on capital gains can end up being both unfair and economically inefficient. (Of course, if the person had the intention of profiting from undertaking this activity, the gain would be taxable. However, intention is difficult to prove and often the gain may end up not being taxed).

Example 2 – Sweat equity

6. Consider an entrepreneur who is prepared to accept a low or even negative cash income from a business in early years in order to build up goodwill in a business and later sell the business for a profit. For example, consider a restaurant proprietor who is willing to accept a low cash income from the restaurant of $40,000 per annum in order to build up a loyal clientele. The build-up of the loyal clientele adds $60,000 per annum to the value of the business and after five years the restaurant proprietor is able to sell the restaurant for a $300,000 gain. Much of this gain will reflect compensation for the labour efforts and business acumen of the owner of

the business. If these gains are not taxed, there will be a bias favouring this sort of activity over undertaking paid employment where income is taxed, or establishing a business where more of the rewards arise as currently taxed income and less arise as capital gains. A tax on capital gains would reduce these biases. It would also make the tax system fairer by making the tax treatment of different forms of income more consistent.

7. It might perhaps be argued that those setting up a business are at times doing something more valuable for society than they would be if they took a job as a salary and wage earner. By setting up a business people may create jobs for others or come out with entrepreneurial ideas leading to wider social benefits. This is no doubt true but any wider benefits to society are unlikely to be closely associated with whether gains from a business are likely to be accruing as capital gains or as income that is taxed. Many people in paid employment also contribute much to wider society while still paying tax on their income. It seems very difficult to adjust taxes to take account of the broader benefits to society of people working in different ways.

8. Our recommended approach to generally tax all forms of income as neutrally as possible reflects the sheer impossibility of working out when specific activities provide wider social benefits justifying a government subsidy.

Example 3 - Risk

9. Consider the case where a taxpayer chooses between two options:

- Earning a salary of $100,000 ($100,000 expected value)
- Forgoing a salary, but trying to create a business that might be worthless (90% chance) or end up being sold for $1m capital gain (10% chance). This option generates $100,000 of expected value.

10. If there were no tax, and a taxpayer was risk-neutral, the taxpayer would be indifferent between the two situations.

11. Now suppose we introduce an income tax (but not tax capital gains) at 30%. The choices are:

- Earn a salary of $70,000 post tax ($70,000 expected value)
- Forgo a salary but try to create a business that might be worthless (90% chance) or end up being sold for $1m capital gain (10% chance) with $100,000 of expected value.

12. By introducing an income tax we have reduced the incentive to work to earn a salary, but maintained the incentive to create a business.

13. If instead we start taxing capital gains, also at 30%, the choices are:

- Earn a salary of $70,000 post tax ($70,000 expected value)
- Forgoing a salary, but trying to create a business that might be worthless (90% chance) or end up being sold for $1m capital gain that is taxable at 30% (10% chance). ($70,000 expected value).

14. By introducing a broader tax on capital gains, we do reduce the incentive to start a business. However, this is only to the same degree that we reduce the incentive to work by taxing salary and wages. Introducing a broader tax on capital gains would

help remove the current bias towards people working to make a capital gain rather than working in paid employment.[1]

Concluding comments

15. The three examples we have provided show how taxing capital gains can reduce incentives for entrepreneurial effort but only to the same extent as an income tax can reduce work incentives more generally. Attempting to tax gains as neutrally as possible reflects the basic idea that "a buck is a buck" and it is fair and efficient to attempt to tax all forms of income as even-handedly as possible. Concerns that taxing capital gains will reduce entrepreneurial effort or investment can be addressed by other neutrality-enhancing measures such as reinstating building depreciation and addressing loss carryforwards and blackhole expenditure.

[1] It is worth noting that even though taxing capital gains will impact on entrepreneurs, there have been a number of leading international entrepreneurs who have advocated taxing capital gains. For example, Warren Buffet and Bill Gates have expressed concerns about the fairness of them not being taxed on the capital gains they derive when many on much lower incomes are taxed at higher rates on their income.