Inland Revenue
Te Tari Taake

POLICY AND STRATEGY

TE TAI ŌHANGA
THE TREASURY

# **Tax Policy Report:** Joint Report: Further advice on capital tax design issues

| **Date:** | 11 March 2019 | **Report No:** | T2019/664<br>IR2019/142 |
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| | | **File Number:** | SH-13-8 |

## Action Sought

| | **Action Sought** | **Deadline** |
|---|---|---|
| Minister of Finance (Hon Grant Robertson) | For information. | |
| Minister of Revenue (Hon Stuart Nash) | For information. | |

## Contact for Telephone Discussion (if required)

| **Name** | **Position** | **Telephone** | | **1st Contact** |
|---|---|---|---|---|
| Steve Mack | Principal Advisor, Treasury | s9(2)(a) | N/A (mob) | |
| Mark Vink | Manager, Treasury | | N/A (mob) | |
| Matt Benge | Chief Economist, Inland Revenue | | s9(2)(a) | |

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

| Return the signed report to Treasury. |
|---|

| Note any feedback on the quality of the report | |
|---|---|

**Enclosure**: No/Yes (attached) OR Yes (iManage links)

# **Tax Policy Report:** Joint Report: Further advice on capital tax design issues

## Executive Summary

This note responds to your request on Thursday 7 March for high-level information about potential options for the extension of the taxation of capital income. The material has been pulled together in haste, it is high level and preliminary.

The tables in appendix 1 set out a brief assessment of the two main options, and suboptions, that you requested. An overview of those options is provided below. Estimates of fiscal costs are provided in appendix 2. Appendix 3 provides more detail about the following:

1. Capital gains discount for individuals
2. Kiwisaver offsets
3. Small business exemptions
4. Real property options
5. Exemption options for residential homes

Some of these options are highly complex and were not considered in-depth during the Tax Working Group (TWG) process. Implementing them within the Government's existing timeframe would create additional risks. These risks could be mitigated by taking a staggered approach to implementation, starting with residential property on the existing time table, and then adding the other components.

Of the options raised to mitigate the impact of taxing capital gains, we recommend the discounted rate rather than exempting certain parts of the base. This comes closer to delivering the benefits of the regime recommended by the TWG than the base exemption options.

**Overview of Main Options**

1. **An extension of capital income taxation – with some concessions**

a) A capital gains discount for individuals (across all asset classes).

- A lower rate is common internationally and it reduces some costs, such as lock-in. It may also be thought of as a partial offset for the taxation of inflation, and providing a concession for long-lived assets that are used to fund retirement[1].
- While a lower rate is not as beneficial as the TWG recommendation for a comprehensive tax, we consider it much preferable to other measures being considered to mitigate the impact of the tax, such as the small business exemption.
- If a lower rate is desired, we recommend the gain be multiplied by a discounted inclusion rate. This achieves the same outcome as a lower rate, but is much simpler

[1] However New Zealand generally taxes retirement savings with far fewer concessions and distortions than other countries. In other areas of the tax system we do not generally index the tax base, and as previously advised, in the case of a *realisation*-based capital gains tax, there is already an offsetting deferral benefit.

than applying a parallel marginal rate structure for capital gains only. This is the approach in Australia. We would suggest a partial inclusion rate of about 75%. Given New Zealand's relatively low top marginal tax rate we consider this in line with tax rates in other countries.

b) Offsetting impacts on kiwisaver:

- The existing KiwiSaver policy provides a significant subsidy (the $521 annual member tax credit). If Minister's wish to provide additional support for KiwiSaver, one option is to adopt all (or some) of the TWG's KiwiSaver recommendations which are :
  - increasing the member tax credit to $.75 per dollar (a maximum of $781.50 per year),
  - reducing the lower PIE tax rates by five percentage points each,
  - rebating ESCT on employer contributions for employees earning up to $48,000 per year (and phasing out the rebate until it is fully phased out for workers earning more than $70,000 per year).

  These measures would be progressive and avoid the distortion of exempting share gains. The total 5-year fiscal cost would be $5 billion Most KiwiSaver investors earning less than $200,000 per year would be better off, assuming they invest 3% of their salary each year (and their employer matches that) and the fund invests 15% in Australasian shares (the average for all KiwiSaver schemes).

- A second option is exempting KiwiSaver from the taxation of Australasian share gains. In the absence of a cap on contributions, this would be highly regressive and incentivise a shift away from direct investment in Australasian shares (and other investment vehicles) towards investment through KiwiSaver accounts[2]. As a result, the fiscal costs could be very large (up to $3 billion over five years) if there is significant reallocation of Australasian shares held outside of KiwiSaver schemes into KiwiSaver schemes. We therefore recommend that any KiwiSaver exemption be accompanied by limits on contributions to mitigate these effects.

- We do not recommend reducing KiwiSaver tax rates (including the top 28% rate) to offset the tax on Australasian share gains. This change would be regressive and have a high fiscal cost unless limits on contributions were imposed.

c) Small business exemptions

- Providing a full exemption for small business would have substantial negative effects on the fairness, integrity, efficiency and revenue benefits of any extension in the taxation of capital income. These negative effects could potentially put at risk the overall net benefits of an otherwise comprehensive extension. A capped exemption, while limiting the negative fiscal and equity effects, would require businesses to calculate and track capital gains, even if they had no tax to pay. Compliance costs would be even higher for businesses with more than one shareholder.

- Our recommended alternative option would be to augment the TWG majority proposal, which included small rollover relief for small businesses, with rollover relief on gifting. This would mean that as long as the proceeds from selling assets are retained within a small business, no tax on capital gains need be levied even if the business is passed down to successive generations.

[2] The TWG recommended that tax apply to Australasian shares when realised (for individuals) or on accrual (for shares held by funds, including KiwiSaver). It did not recommend changing the taxation of non-Australasian shares, which is usually the fair dividend rate method. There are arguments for and against taxing non-Australasian shares in the same way as Australasian shares. If there is an exemption for gains on Australasian shares held in KiwiSaver, then the case for changing the way we tax non-Austalasian shares is reduced.

2. **Targeted extension of capital income taxation – real property**

a) Real Property (Land and Buildings) Options

- Compared with the status quo, the broader the base in extending the taxation of capital gains across real property classes, the greater the gains in efficiency, integrity and equity benefits. However,
    - If second homes are not included in the base there would be negative effects on housing supply and some additional complexity relating to distinguishing between rentals and second homes
    - The taxation of gains on commercial, industrial and rural land would involve complexity in dealing with land owned by businesses.

- Compared with the TWG's recommended broad taxation of capital gains, all of these options would offer much reduced integrity and equity benefits.

b) Options for exempting residential properties

- Exempting more properties, in addition to the family home, would generally reduce the efficiency and equity of capital gains taxation, and would lead to an increase in complexity given the need to distinguish between different property types. If the additional exemption only applied to second homes (not rentals), there could also be negative housing supply effects.

- If Ministers wished to allow more exempt more properties, we would recommend ("2a") as the least complex and most efficient and horizontally equitable of the options.

## Recommended Action

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

Mark Vink
**Manager, Tax Strategy, Treasury**

Matt Benge
**Chief Economist, Inland Revenue**

Hon Grant Robertson
**Minister of Finance**
/ /2019

Hon Stuart Nash
**Minister of Revenue**
/ /2019

# An extension of capital income taxation – with some concessions

Green = positive or broadly neutral impact
Orange = some negative impacts
Red = substantially negative impacts

## Capital gains discount - relative to the TWG design of a comprehensive capital gains tax

| Option | Efficiency | Equity | Integrity | Complexity | Cost | Comment |
|---|---|---|---|---|---|---|
| **Capital gains discount**<br>*Allow individuals to discount their capital gains by, say, 25%* | Reduction in positive & negative effects relative to a comprehensive tax | Reduction in equity benefits relative to a comprehensive tax | Reduction in integrity benefits relative to a comprehensive tax | Some additional complexity arises from use of discounting | Up to $2.1 b | **Officials see a discount as a preferable option to exemptions.** |

## KiwiSaver (KS) exemption options - relative to the TWG design of a comprehensive capital gains tax

| Option | Efficiency | Equity | Integrity | Complexity | Cost | Comment |
|---|---|---|---|---|---|---|
| **1. TWG savings measures**<br>*Increase member tax credit, reduce ESCT, reduce KS PIE rates.* | Favours saving in KS over other vehicles, but effects are small. | Increases progressivity - but only for those able to save via KS. | No impact. | Small impacts only (arising from distinctions between KS and other PIEs). | $5.0 b | None of these options is likely to have a material impact on the amount of private saving.<br><br>Option 1 is the most progressive & least distortionary option. Even if not all of the TWG savings measures are adopted, most KiwiSavers will be better off, relative to the status quo.<br><br>Options 2 and 3 are the most regressive and have the highest efficiency costs. Introducing a cap on contributions will substantially reduce these negative effects. |
| **2. Australasian shares**<br>*The TWG recommended no change to the FDR regime, so this option equates to a complete exemption.* | Favours saving in KS; may reduce liquidity in NZ capital markets. | Very regressive. | No impact. | Less complex. | Up to $3.0 b | |
| **2a. Australasian shares, with contributions cap**<br>*Cap on tax-preferred contributions to KS.* | Favours saving in KS, but effects are limited by cap. | Somewhat regressive. | No impact. | Some complexity arises from introduction of cap. | $0.8 b | |
| **3. Lower KS PIE rates by 1, 2, 3 percentage points**<br>*Reduce all PIE rates for KiwiSaver funds. Rates would 9.5%, 15.5%, 25%.* | Favours saving in KS; may reduce liquidity in NZ capital markets. | Very regressive. Some KiwiSavers may experience inconsistent outcomes. | Somewhat higher integrity risks. | Small impacts only (arising from distinctions between KS and other PIEs). | Up to $1.5 b | |
| **3a. Lower KS PIE rates by 1, 2, 3 percentage points, with contributions cap**<br>*Cap on tax-preferred contributions to KS.* | Favours saving in KS, but effects are limited by cap. | Somewhat regressive. | No impact. | Some complexity arises from introduction of cap. | $0.6 b | |

## Small business exemption options - relative to the TWG design of a comprehensive capital gains tax

| Option | Efficiency | Equity | Integrity | Complexity | Cost | Comment |
|---|---|---|---|---|---|---|
| **1. Capped lifetime exemption**<br>*Lifetime exemption of up to $500k for gains on active assets from small active businesses* | Productivity risk (investment bias). | Reduces horizontal equity & progressivity of tax. | Compromises integrity benefits of tax. | More complex business must track gains over time. | N/A* | Officials do not support these options - but Option 3 has fewest drawbacks.<br><br>Better options to help small business are:<br>• **Immediate expensing**<br>• **Reducing costs of compliance**<br>• **Delayed application to small business** |
| **2. Uncapped lifetime exemption**<br>*Uncapped exemption for capital gains on active assets related to small active businesses.* | Productivity risk (large investment bias). | Reduces horizontal equity. Most regressive option. | Highest integrity risks. | Less complex – businesses do not need to track gains over time. | N/A* | |
| **3. Rollover relief**<br>*In cases of reinvestment, death, and family gifting.* | Little impact, possibly positive. | Little impact. | Low risk. | Business will need to keep track of costs. | N/A* | |

Fiscal costs over five years – represent the decrease in revenue relative to the TWG design of a comprehensive capital gains tax.

*TWG projections doe not incorporate revenue from the sale of businesses

# Targeted extension of capital income taxation – real property only

Green = positive or broadly neutral impact
Orange = some negative impacts
Red = substantially negative impacts

## Real property options – relative to the TWG design of a comprehensive capital gains tax

| Option | Efficiency | Equity | Integrity | Complexity | Cost | Comment |
|---|---|---|---|---|---|---|
| **1. Tax gains on all real property**<br>*Tax gains on all residential, commercial, industrial & rural land.* | IR: Net negative impact.<br>Tsy: Net positive impact. | Regressive relative to comprehensive tax. | Does not address key integrity issues. | Key complexity is dealing with land owned by businesses. | $4.0 b | The simplest option to implement is to tax **residential rentals & second homes** only.<br><br>If Ministers wish to tax gains on all real property, officials recommend **further engagement with Māori** to identify potential impacts on collectively-owned assets and entities. |
| **2. Tax gains on all real property, except rural land**<br>*Tax gains on all residential, commercial & industrial land.* | Rural land exemption generates new distortions. | Regressive relative to comprehensive tax. | Does not address key integrity issues. | Key complexities are land owned by businesses & establishing boundary of rural land. | $4.8 b | |
| **3. Tax gains on residential rentals & second homes only** | IR: Net negative impact.<br>Tsy: Net positive impact. | Regressive relative to comprehensive tax. | Does not address key integrity issues. | Simpler to design. | $6.0 b | |
| **4. Tax gains on residential rentals only** | May reduce supply of rental housing. | Regressive relative to comprehensive tax. | Does not address key integrity issues. | Simpler to design. | $6.4 b | |

## Options for exempting residential properties – relative to the TWG design of a comprehensive capital gains tax

| Option | Efficiency | Equity | Integrity | Complexity | Cost | Comment |
|---|---|---|---|---|---|---|
| **1a. One exempt property per person in addition to the family home – may be a rental property** | Smaller reduction of bias in favour of residential investment. | Regressive and reduction in horizontal equity. | No obvious risks. | Small impacts. | $1.2 b | Allowing an additional exempt home is **regressive** and will **reinforce the bias** to invest in residential property.<br><br>Excluding rental homes from the exemption may have negative housing market impacts. |
| **1b. One exempt property per person in addition to the family home – but may <u>not</u> be a rental property** | May reduce supply of rental housing. | Regressive and reduction in horizontal equity. | No obvious risks. | Need to determine if property is rental. | $0.4 b | |
| **2a. One exempt property per person – may be family home, bach, or rental** | Affects more properties and increases investment bias to residential property. | Regressive and reduction in horizontal equity. (But fairer for people who own a property they do not live in.) | No obvious risks. | Least complex. | $0.9 b | |
| **2b. One exempt property per person – may be family home or bach, but <u>not</u> rental** | May reduce supply of rental housing. | Regressive and reduction in horizontal equity. | No obvious risks. | Need to determine if property is rental. | $0.4 b | |

Fiscal costs over five years – represent the <u>decrease in revenue</u> relative to the TWG design of a comprehensive capital gains tax.

# APPENDIX 2

# FISCAL IMPACTS

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| Taxing capital gains – different asset coverage | Revenue decrease over five years |
|---|---|
| Tax gains on all real property | $4.0 billion |
| Tax gains on all real property, except rural land | $4.8 billion |
| Tax gains on residential rentals and second homes only | $6.0 billion |
| Tax gains on residential rental only | $6.4 billion |

| Capital gains discount | Revenue decrease over five years |
|---|---|
| Allow individuals to discount their capital gains by 25% | Up to $2.1 billion |

[3] Revenue-neutral being that the fiscal costs from 2021-26 match the revenue from taxing capital gains over this period.

| **Savings concessions** | **Revenue decrease over five years** |
|---|---|
| Increase member tax credit from $0.50 to $0.75 per $1 of contribution | $2.6 billion |
| Refund ESCT for earning less than $48,000. Abate refund by 6 cents per dollar for those earning more than $48,000 | $1.7 billion |
| Decrease lower KiwiSaver PIE rates | $0.7 billion |
| Australasian shares held by KiwiSaver are exempt | Up to $3 billion |
| Australasian shares held by KiwiSaver funds are exempt, alongside caps to tax-preferred contributions to KiwiSaver | $0.8 billion[4] |
| Lower all KiwiSaver PIE rates by 1/2/3 percentage points (*New rates 9.5%, 15.5%, 25%.)* | Up to $1.5 billion |
| Lower KiwiSaver PIE rates by 1/2/3 percentage points, with contribution cap | $0.6 billion |

| **Options for exempting residential properties (relative to the TWG's 'main home' exemption)** | **Revenue decrease over five years** |
|---|---|
| One exempt property in addition to the family home – may be a rental property | $1.2 billion |
| One exempt property in addition – but may not be a rental property | $0.4 billion |
| One exempt property per person – may be family home, bach or rental | $0.9 billion |
| One exempt property – may be family home or bach, but not rental | $0.4 billion |

[4] This assumes that there are strong limits on contributions to KiwiSaver. Costing assumes that 10% of directly held investments in Australasian shares move to KiwiSaver funds as a result of the exemption.



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# APPENDIX 3

# DISCUSSION OF SCOPE AND MITIGATION OPTIONS FOR TAXING CAPITAL INCOME

## CAPITAL GAINS DISCOUNT FOR INDIVIDUALS

### Objective

1. This option allows individuals to discount their capital gains by 25% (or any other number). This is sometimes known as "partial inclusion". The discount would also apply to trusts, KiwiSaver funds and other PIEs. The discount might be thought of as addressing several issues:

   - A partial offset for the taxation of **inflation** in capital gains.
   - Recognising that **"lock-in"** is lower by having lower inclusion rates.
   - Providing a concession for long-lived assets that have capital gains that are often used to fund **retirement**. The discount would also apply to KiwiSaver funds.

2. As such, a capital gains discount is a way of recognising concerns raised on **inflation**, **lock-in, and retirement**.

3. It is similar in effect to having a lower capital gains tax rate, but allows this to flow through to taxpayers of all income levels, instead of maintaining a parallel rate structure.

### Impacts on revenue

4. Because it only applies to individuals, the revenue estimates do not decline at a linear rate with the discount. That is, a 25% discount reduces revenues by **less** than 25%. Because we do not have good data on capital gains realised by companies as compared with individuals, it is not possible at this stage to accurately model this effect. Over the first five years, the revenue raised from a 25% discount would be **greater than $6.2 billion** (which is 75% of $8.3 billion).

### Impacts on equity

5. Relative to full inclusion, the discount introduces some aspects we do not have in the rest of our tax system:

   - ***It is a partial offset for the tax on inflation***. Capital gains due to inflation are not real income. By only taxing some proportion of capital gains, a discount is a simple way to reduce or remove the tax on expected inflation. We note, however, that we do not systematically attempt to reduce the tax on inflation throughout the rest of the tax system (eg on interest income).
   - ***It allows for concessionary treatment of retirement savings***. Long-term capital gains are part of retirement savings. To achieve social policy goals the government offers concessions on other forms of retirement earnings, and a discount offers a simple method for applying similar concessions to the treatment of capital gain income. We note, however, that New Zealand generally taxes retirement savings with far fewer concessions and distortions than other countries.

6. This has inconsistent equity implications – as it treats capital gains differently than other capital income.



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## Impacts on integrity and complexity

7. A discount for individuals does increase complexity relative to full inclusion. This is because individuals still have to work out what are capital amounts and what are revenue amounts. This creates boundary issues that would have to be resolved.

8. Just as with full comprehensive taxation, there are still the complexities from valuation day and record-keeping with the discount.

## Impacts on efficiency

9. A capital gains discount moderates the efficiency benefits and costs relative to full inclusion for individuals. There are three areas where the taxation of capital gains has efficiency or productivity costs which a discount will help alleviate:

- ***It lowers tax burdens on these forms of investment***: A discount will see the tax on those who invest in asset that appreciate increase by less, reducing the risk that overall investment will decline. The full effect on investment will depend on the revenue from the tax is spent.
- ***It removes or reduces the tax on expected inflation***. The taxation of inflationary gains was the key reason why overall investment was expected to be reduced by taxation of capital gains. If expected inflation is removed with a discount, then these investment/productivity costs are lower.
- ***It reduces lock-in***. A discount reduces the tax benefit associated with deferring the sale of an asset, which will reduce the costs associated with lock-in.

## Other considerations

10. A capital gains discount is relatively common in other countries. Australia, Canada and Portugal provide a 50% discount. South Africa provides a 60% discount.

11. For a taxpayer on the top personal rate in each of these countries, the final rate for capital gains is:

| Country | Top personal rate | With discount |
|---|---|---|
| Australia | 47% | 23.5% |
| Canada | 41.5% - 54% (depends on province) | 20.75% - 27% |
| Portugal | 48% | 24% |
| South Africa | 45% | 18% |
| New Zealand (assumes 25% discount) | 33% | 24.75% |

12. The tax extension outlined by the TWG, coupled with a discount for individuals, brings the regime designed more in line with many other countries.

## Capital gains discount vs a separate capital gains tax at a lower rate

13. A capital gains discount is preferable to having a separate capital gains tax for two reasons. Those are:

- it creates simplicity in calculating your ultimate tax liability because of integration with the existing income tax instead of a separate tax.
- It allows marginal rates to apply. In the absence of this, some taxpayers are likely to end up being taxed at higher rates on capital gains than they are on the rest of their income. (E.g. a pensioner on on a 17.5% rate who sells some shares will be taxed more highly on their share gains if the capital gains tax rate is above 17.5%).



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## AUSTRALASIAN SHARE GAINS AND KIWISAVER

14. We understand your objective is to ensure that KiwiSavers are no worse off under a comprehensive capital gains tax as recommended by the TWG. This notes sets out 3 options to achieve this.

15. Increased taxation is only an issue for Australasian shares, on which KiwiSaver funds are currently exempt from tax. Australasian shares make up 15% of all KiwiSaver fund assets.

16. It is not necessary to accept any of the three options. Another option is to retain status quo KiwiSaver incentives (the member tax credit). This already provides a significant subsidy for most members and would help to ensure that KiwSaver remains an attractive investment vehicle even if Australasian share gains were taxed.

### Options

### Option 1: Accept TWG recommendations.

17. The TWG recommendations were to tax gains on Australasian shares, but provide offsetting benefits to low and middle income earners. These benefits are:

- higher member tax credits ($0.50 to $0.75)
- ESCT rebate for income under $48,000 (phasing out to $70,000);
- Reducing the bottom two KiwiSaver tax rates from 17.5% to 12.5% and from 10.5% to 5.5%;
- Full member tax credits for KiwiSavers on parental leave, regardless of contributions.

18. We estimated these benefits, if all adopted, would more than offset the cost of taxing gains on Australasian shares for the great majority of KiwiSaver. Assuming historical returns and the average 15% portfolio investment in Australasian shares, KiwiSavers earning less than $200,000 per annum would be better off.

### Option 2 – exempt gains on Australasian shares held by KiwiSaver funds.

19. This would retain the existing KiwiSaver tax treatment. If we assume no behavioural change, the fiscal cost is manageable ($520 million over the first five years). However, there is significant fiscal risk if we assume behavioural change to take advantage of the exemption (up to $3 billion over five years if there is reallocation of share investments). We would recommend some limitations to manage potential behavioural changes, eg. capped contributions or benefits (ie. the exemption only applies up to a certain amount of gain from Australasian shares).

20. This approach is the simplest in principle, as it maintains the status quo. However it will become more complicated as we add measures to manage the fiscal risk.

21. A potential cap on annual contributions could include a maximum percentage of income (eg. 10%) or a fixed amount (eg $10,000). We recommend a fixed amount, say $10,000. A percentage of income approach means higher income savers could make larger investments and gain more benefit from the exemption than lower-income savers. A cap of $10,000 represents the amount someone earning about $167,000 per year would contribute to KiwiSaver if they make a contribution of 3% that is matched by a further 3% employer contribution.

22. A disadvantage of the cap is it would limit future growth of KiwiSaver. However, savers will still be free to save outside of KiwiSaver.

23. To manage fiscal cost, an exemption could replace some of the TWG's recommendations, such as increasing the member tax credit (which is the most expensive), or rebating ESCT for low-income savers, which is administratively complex.

## Option 3 - lower KiwiSaver PIE rates

24. This option would reduce KiwiSaver PIE rates by 1, 2, and 3 percentage points so they become 9.5%, 15.5% and 25%. This is to offset the taxation of share gains for all KiwiSavers. The greater reduction for the higher PIE rates is because the impact of taxing capital gains is greater for them.

25. We do not recommend this, as it is not targeted and it would not be accurate as different KiwiSavers will be invested in different proportions of Australasian shares (meaning some will be better off while others will be worse off compared with the status quo, depending on their proportionate investment in Australasian shares).

26. The fiscal cost of this, when assuming no behavioural change is approximately $0.6 billion. However, if people are able to make unlimited contributions to KiwiSaver then the fiscal cost is potentially greater and for example if all PIEs converted to KiwiSaver this would reduce revenue by approximately $1.5 billion over five years. To manage this we would recommend a contribution cap if this option was pursued (say $10,000 per year contribution cap).

## Comments

27. We note that a full exemption for Australasian shares:

- would be regressive, as it will benefit the wealthiest the most (although this could also be mitigated, but not eliminated, with caps). We note that 84% of all financial assets are held by the top quintile, which suggests that most of the benefit of an exemption would also flow the top quintile in the absence of limitations.

- could adversely affect New Zealand's capital markets. If people switch from investing in the NZX directly to investing via KiwiSaver, then the liquidity of the NZX could significantly reduce with the smaller number of total investors. This concern was raised publicly during the TWG process. On the other hand, a full exemption may increase the total funds invested in the NZX.

- would be simple in principle, but contribution caps would complicate it, and would limit the amount people could save through KiwiSaver. Benefit caps would not limit the amount that could be saved, but these would be more complicated and KiwiSaver funds may have trouble implementing them given their current daily calculation method.



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28. If we adopt option 1 or 3, there is a question as to whether we should tax non-Australian shares under FDR or on dividends and capital gains. However if we adopt option 2 (and exempt Australasian shares) there is less reason to consider changing the tax treatment of non-Australasian shares.

## Recommendation

29. We recommend the Government either do nothing or adopt Option 1 (Accept TWG recommendation). If the Government wanted to adopt option 2 (exempt gains on Australasian shares), then we consider this would be viable if combined with a $10,000 per annum contribution cap.

# SMALL BUSINESS AND FARMS EXEMPTION FROM CAPITAL GAINS TAX

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## Purpose of measure

1. A clear carve-out or exemption for small businesses (and farms) from capital gains taxation.
2. The measure would apply to active small businesses and not passive investments held in companies and trusts.
3. Exemptions would apply to capital gains arising on the sale of a business by the owner and on sales of assets by the business.

## Options

### 1. Lifetime exemption up to $500,000 of capital gains on active assets for small businesses

4. Small businesses and their owners would be allowed to earn up to $500,000 of capital gains on active assets tax-free over the owner's lifetime.

### 2. Uncapped exemption on capital gains on active assets for small businesses

5. Exemption as above, but without a cap.
6. Australia has exemptions similar to the above, but they are linked with the Australian retirement system.

### 3. Roll-over relief for small businesses

7. The proposal builds upon the roll-overs for small businesses proposed by the TWG. Rollovers would be provided when:
   - The proceeds are reinvested in a small business;
   - On inheritance; and,
   - When gifted to family members.
8. Tax would be only payable on capital gains when the business was cashed out or sold to third parties. Small businesses and farmers would not have to pay capital gains tax as long as the family keeps the funds in the business. They would not, however, fully carve out small businesses from tracking costs for eventual taxation.

## Targeting

9. It is necessary to provide rules to target the measure to the appropriate taxpayers and activities. Targeting provisions can be a source of significant complexity. Provisions would be required to:

## Define small businesses

10. It is necessary to define which businesses qualify as small businesses. The Group proposed a limit of $5 million of sales for their reinvestment roll-over proposal. Further consideration on a robust and simple definition is necessary.

## Define active business activities

11. A significant challenge is to define business activity as opposed to passive investments. Otherwise passive assets the capital gains on which should be subject to tax can be placed in active businesses and sheltered from tax.

## Apply a cap

12. Applying a lifetime cap can limit revenue loss. Rules are required to prevent the cap from being multiplied. It is necessary to keep track of capital gains relative to the cap.

## Impact on objectives

13. The issues for each of the options are similar.

## Revenue

14. Providing an exemption for active small businesses would eliminate most revenues from taxing capital gains of small businesses over the short term.

15. There would be significant revenue risks if larger businesses and non-active investments could be structured to qualify for the exemption. Risks are significant for Options 1. and higher for Option 2.

## Fairness

16. Horizontal equity would be reduced as taxpayers earning capital gains on a small active business would pay less tax that taxpayers earning the same level of other income.

17. The progressivity of the tax system would be reduced as exempt capital gains are likely to be concentrated at higher wealth individuals. Option 2. would be the more regressive option.

18. The roll-over option would tax funds that were withdrawn from the business, improving fairness relative to an exemption.

## Efficiency

19. Efficiency would be reduced to the extent that investments are directed to lower productivity activities due to the exemption. On the other hand, lock in effects would be eliminated.

20. Roll-overs would facilitate efficient business relocations and redirections by eliminating capital gains taxation of the transactions.

21. The threshold could cause behavioural changes as businesses approach the threshold.

## Sustainability

22. If in the future company and the top personal tax rates were to diverge further, there would be increased pressure on dividend avoidance. This problem arises with closely-held businesses, and is deterred by taxing capital gains. The exemption would mean that the problem would persist.

## Integrity

23. The exemption would significantly compromise the integrity benefits of introducing capital gains taxation. There are also significant integrity challenges in the design of the exemption. The challenge is to target the measures to the intended businesses and activities. Risks include:

*Multiplication of the small business limit*

24. It is necessary to share the size limit across commonly-owned or controlled entities to ensure that large businesses cannot access the exemption.

*Multiplication of the exemption cap of $500,000*

25. Splitting ownership across a family, including children, can multiply access to the exemption.

*Non-active activities*

26. Passive investments like listed shares, land, and rental properties would need to be carved out of the exemption, both when assets are sold in a business and when the business is sold (complex). For example, real property associated with an active business like a farm, plant, shop or office used in a business would be exempt. But residential and commercial real estate that is let out would be taxable.

*Dividend avoidance*

27. A current problem arises from arrangements that exploit the non-taxation of capital gains to convert taxable dividends into exempt capital gains. This is a problem for closely-held companies. The exemption would maintain the problem, requiring special rules to deal with it.

28. The roll-overs would ensure taxation when the funds were withdrawn from the business reducing the potential for dividend avoidance.

## Complexity

29. Option 1, the $500,000 exemption, would require businesses to calculate capital gains and keep track of their exemption amount. Thus, it would be as complicated as paying the tax and perhaps more so due to the need for anti-avoidance rules. Option 2, the uncapped exemption, would remove the need to calculate or keep track of gains

30. Complex rules would be required to coordinate capital gains made in a company with the share-holder's capital gains relative to the $500,000 exemption cap.

31. All options would require complex rules to target the exemption to the desired activities. Failure to do so would impose significant revenue risks.

## Overall assessment

32. Exemption from tax on capital gains for small businesses significantly compromises the Government's fairness objective, adds considerable complexity and introduces significant risks to revenues.

33. A $500,000 exemption would not simplify compliance for many small businesses; and could increase it for some. An uncapped exemption would increase revenue risks and reduce progressivity.

34. Exemptions are not recommended by officials.

35. Roll-overs provide many of the benefits of an exemption for small businesses at lower compliance cost, with fewer revenue and integrity risks.

## Alternatives for consideration

36. In addition to the roll-overs, there are alternative ways of reducing taxes for small businesses that may be simpler than an exemption from capital gains. These are

- A lower tax rate for capital gains from a small business or farm on retirement as proposed by the TWG.
- Partial expensing of capital investments. Partial expensing is equivalent to applying a lower tax rate to income arising from the investment. However, it avoids many of the problems associated with a low tax rate.
- A low tax rate for income earned by small businesses.

37. A low tax rate for small businesses was considered and rejected by the TWG. A low tax rate requires complex rules and raises integrity problems similar to an exemption for capital gains as taxpayers attempt to have non-business income taxed at the lower rate. It is less effective in promoting new activity than partial expensing as it lowers taxes on investments that have already been made.

# OPTIONS FOR TAXING MORE CAPITAL GAINS FROM LAND

## Overview

30. You have asked us to provide you with further advice around alternative options for limiting taxing more capital gains to land (including buildings and all other improvements to land). You have suggested four possible options for consideration being:

    - Option 1: Only tax capital gains from residential rental properties
    - Option 2: Tax capital gains from residential rental properties and second homes
    - Option 3: Tax all capital gains from land
    - Option 4: Tax capital gains from all land excluding rural land

31. This note briefly summarises the key impacts of each of these options. The table at the end summarises the impacts of each option more fully.

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

## Options

## Option 1: Residential rental properties

33. The first option is to only extend taxation of capital gains to residential rental properties.

34. This will broaden the base. It is expected this would raise $1.9 billion over 5 years. This option excludes properties that are used privately, for example a holiday home. It is relatively simple, reduces the difficulty of the initial Valuation Day exercise (as compared to a comprehensive extension) and provides a modest improvement in equity. However, it does little for sustainability or coherence of the tax system.

35. Relative to Option 2 (taxing all residential property) it raises the following concerns:

    - If second homes are not taxable there is the risk that taxpayers anticipating capital gains would leave them untenanted in order to avoid the tax that would apply to rental homes, thus reducing housing supply.
    - It adds a complex factual boundary between residential rental properties and second homes, particularly where there is mixed use of a property (e.g. where properties are rented part of the time).



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## Option 2: Residential rental properties and second homes

36. The second option is to tax all residential land. This includes land used as rental properties and second homes/holiday homes.

37. Around one third of capital gains are expected to be on residential rental property and second homes. It is expected that taxing these capital gains will raise more tax - $2.3 billion over 5 years.

38. This option has similar advantages and disadvantages to Option 1. However, this option resolves issues that arise from excluding second homes and, in particular, will not encourage vacant homes.

## Option 3: All land

39. The third option is to extend taxation of capital gains to all land.

40. An extension of taxing capital gains to all non-owner occupied land is estimated to raise $4.3 billion over 5 years. Compared to Options 1 and 2 this will improve horizontal equity but still leaves other business assets and shares untaxed. The Valuation Day issues will be more complex than for Options 1 and 2 but less than for a comprehensive tax. However, this option is likely to be just as complex as a comprehensive capital gains tax.

## Option 4: All land excluding rural land

41. The last option is to tax all land excluding rural land.

42. This would exclude gains from farming and other rural uses (such as forestry) from the tax. It is estimated this option would raise $3.5 billion over 5 years.

43. This will have similar advantages and disadvantages to Option 3. However, it will require "rural land" to be defined and may create incentives to retain land as rural land rather than developing it for residential or other purposes.

## Preferred options

44. Officials would not recommend adopting Option 1 (taxing only residential rentals). This is because of the risk that second homes would become untenanted.

45. Option 2 (taxing residential rental and second homes) would be a good stepping stone to a comprehensive extension of taxing capital gains.

46. Officials would prefer Option 3 (taxing all land) over Option 4 (taxing all land excluding rural land) because it is more comprehensive

| Key Factors | | Option 2: Residential rental and second homes | Option 3:<br>All land | Option 4:<br>All land excluding rural land |
|---|---|---|---|---|
| **Complexity** | | • As for Option 1<br>• Removes factual boundary between rental and second homes | | • As for Option 3<br>• Adds some complexity in defining what is rural land, particularly compared with lifestyle blocks |
| **Efficiency/ Productivity** | | • As for Option 1<br>• Removes risk that houses would be left vacant | | |
| **Integrity** | | • As for Option 1<br>• Removes risk that houses would be left vacant | | |
| **Equity** | | • As for Option 1 | | • As for Option 3, but no harsher treatment for rural land |
| **Revenue impact** | • Estimated revenue: $1.9 billion | • Estimated revenue: $2.3 billion | • Estimated revenue: $4.3 billion | • Estimated revenue: $3.5 billion |

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## DETERMINING EXEMPT RESIDENTIAL PROPERTY

47. This note discusses options for exempting residential property from a capital gains tax, in addition or instead of a main home exemption. The options may address concerns that people with the following properties would be subject to tax:

- Bach owners;
- Mum and dad investors with one rental property; and
- People who live in a home they do not own, but own a property (which may or may not be rented out) in a different location.

### Options

***Option 1: Every person would get one exempt property in addition to their family home that they live in.***

48. Under this option every person would be entitled to up to two exempt properties at any given point in time.

49. There are two sub-options that can be considered under this option:

- **Option 1A:** The additional exempt property could be a second home or bach or could be a rental property.
- **Option 1B:** The additional exempt property cannot be a rental property.

***Option 2: Every person would get one exempt property***

50. Under this option every person would be entitled to up to one exempt property at a given time that may or may not be their family home.

51. As above, there are two sub-options that can be considered under this option:

- **Option 2A:** The exempt property could be a main home, second home or bach or could be a rental property.
- **Option 2B:** The exempt property cannot be a rental property.

***Additional options: Value cap or allowance***

52. The Tax Working Group recommended that the Government consider a cap on the value of the properties subject to the main home exception but considered it outside the scope of their terms of reference. A value cap would be intended to address the "mansion effect", where capital is invested into homes rather than more productive uses. A value cap could increase fairness and reduce the fiscal cost. However, it introduces more complexity.

53. All 4 options discussed above are likely to reduce revenue relative to having an exemption for just main homes. All 4 options would also reinforce the bias to invest in residential property. A value cap may therefore be appropriate if any of the 4 options are preferred to an exemption for just the main home.

54. Overall, options 1A and 1B are likely to reduce revenue, equity and efficiency more than options 2A and B. A value cap may therefore be more appropriate if either option 1A or 1B is chosen. Under option 1 the value cap could apply to both the main home and the additional exempt property or just the additional exempt property.

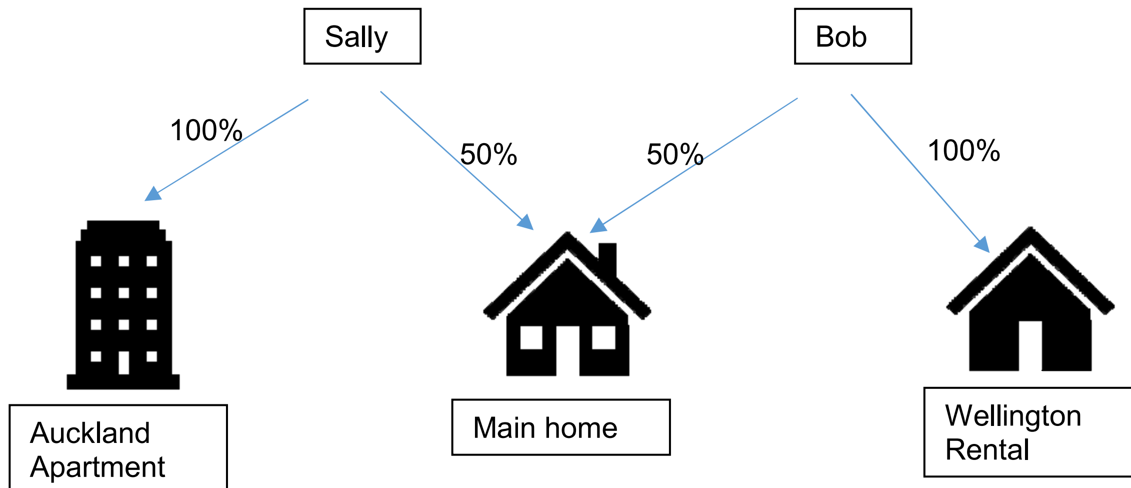
55. An alternative to a value cap that has not been explored fully is an allowance for each person (of, for example $2 million) that applies to residential property (either including or excluding rental property) that person owns. There would not be a cap on the number of properties a person could exempt, but if the sum of the value of residential properties a person owns exceeds the allowance they would be required

to pay tax on a proportion of any capital gains they make. This may provide fairness benefits (including geographical equity) but is likely to introduce significant complexity to the rules compared to the Tax Working Group's proposal or options 1 and 2.

## Example

56. The following example is used to illustrate how Options 1 and 2 described above would work in practice.

57. Sally and Bob jointly own a main home together in Wellington. Sally also owns an apartment in Auckland where she stays 3 days a week while in Auckland for work. Bob also owns a rental property in Wellington.




| Option 1A (family home and one other property) | Option 1B (family home and one other non-rental property) |
|---|---|
| All 3 properties in the example above would be exempt. | Sally and Bob's main home and Sally's Auckland apartment would be exempt.<br><br>Bob's rental property would not be exempt. |
| **Option 2A (one property, any use)** | **Option 2B (one property, any non-rental use)** |
| Sally and Bob would each be entitled to exempt one property.<br><br>Sally could either exempt her Auckland apartment or exempt her 50% share of the main home and 50% of her Auckland apartment.<br><br>Bob could either exempt his rental property or exempt his share of the main home and 50% of the rental property. | Bob can exempt his 50% share of the main home. His rental property cannot be exempted.<br><br>Sally can either exempt her Auckland apartment or her 50% share of the main home and 50% of her Auckland apartment. |

## Recommendation

58. We recommend the Tax Working Group's option of just exempting the main home.

59. We consider that there is a case for option 2A, on grounds of compliance cost reduction and fairness grounds. However, this should be weighed against the fiscal cost of option 2A.

60. We do not recommend options 1A, 1B or 2B.