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SUBMISSIONS TO THE TAX WORKING GROUP 2018

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INTRODUCTION

1. I am a Professor of Law at the University of Auckland Law School. My principal field of expertise is tax law and tax policy. I have published extensively in these areas both in New Zealand and in other countries. I am a fulltime academic but I have also from time to time provided advice to individuals, business interests and the governments of several countries. I make these submissions in my personal capacity.
2. On 14 March 2018 the Tax Working Group recently established by the government published a paper called *Future of Tax: Submissions Background Paper*. The Working Group (at page 46) called for submissions addressing six main questions. It also asked a number of other questions, most importantly a series of more specific questions relating to the design of a possible capital gains tax (CGT).
3. These submissions are arranged as follows. This Introduction is followed by a Summary of key points. The Summary, in turn, is followed by submissions addressing the Working Group's six main questions and the specific questions about a CGT. Finally, the submissions discuss the possibility of introducing a tax on sugary drinks.
4. I would be happy to answer any questions and to discuss any aspect of the Working Group's work with the Group or its secretariat.

SUMMARY

5. The principal points made in these submissions are as follows. First, the current non-taxation of capital gains is both inequitable and inefficient. The optimal course for the government to take, however, would be *not* to introduce a general CGT but, rather, to introduce specific CGTs on two of the more important classes of capital gains (namely gains made by companies and gains made on listed shares and other listed securities), supplemented by an annual land tax (chargeable on all land other than the family home and, perhaps, Māori land).

6. The overall result would be broadly similar to a general CGT, but the legislation would be incomparably simpler and the costs of compliance and administration would be far less. In particular, the two specific CGTs could be established by simply extending the definition of income, for income tax purposes, so as generally to include (a) gains made by companies and (b) gains made on listed shares and other listed securities; and the annual land tax could be established on the same basis as the existing system of local government rates.

7. Reform of this nature (specific CGTs on capital gains made by companies and gains made on listed securities, plus a land tax) would leave important classes of capital gains generally untaxed, as at present – in particular, gains made on shares in unlisted companies, gains made on interests in unincorporated businesses, and gains made on collectibles (works of art, antiques, etc). But taxing gains of these sorts raises difficult questions of policy and entails considerable complexity. Indeed, *most* of the complexity of most countries' CGTs seems to be the result of including gains of these kinds within the scope of the tax. Moreover, in most countries the revenue derived from taxing gains on small businesses is substantially less than it would otherwise be because of the various reliefs offered. Further, such reliefs usually seem to aggravate the complexity and to be susceptible to abuse. Another reason for leaving shares in unlisted companies and interests in unincorporated businesses outside the tax net is that it would be an effective method of encouraging entrepreneurialism and supporting small businesses (and would obviate the need for other preferences, such as a progressive company tax). As for taxing gains made on collectibles, it seems unlikely that that would generate significant revenue, especially given the ease with which most collectibles could be removed from the jurisdiction.

8. Because of the peculiar nature of the market in agricultural and horticultural land, it is possible that imposing a tax on those kinds of land would be problematic. If so, that problem could be solved by offering the owners of agricultural and horticultural land the choice of either paying the land tax or paying income tax on any gain made on sale of the land.

9. The government should also investigate further the possibility of an emissions tax based on the destination principle – that is, applicable to goods and services consumed in New Zealand, but not on exports. It should also increase the tax on cars, but with an exemption for electric cars and cars that use relatively little petrol or diesel.

10. It would be a mistake for the government to exclude from GST anything at all that is not currently excluded.

11. The grounds upon which these points are based are set out below.

QUESTION 1

How, and to what extent, does the tax system affect housing affordability for owners and renters? Is there a case to change the tax system to promote greater housing affordability? If so, what changes would you recommend?

12. The cost of housing, measured against incomes, appears to be higher in New Zealand than almost anywhere else in the world. It seems probable that this is mainly due to factors other than tax. It is possible, however, that the tax system has exacerbated the problem because under the current law (a) landlords are permitted to set off operating losses on investment properties against other income and (b) capital gains are generally not taxed. The consequence of these two factors is that landlords are commonly prepared to operate their investment properties at a loss (mainly as a result of interest deductions) with a view to later making a tax-free capital gain; and that, in turn, means that they are presumably prepared to pay more for houses than they otherwise would – thus pushing up prices. In other words, the tax system, as currently structured, effectively subsidises landlords.

13. It would be possible to substantially reduce the subsidy referred to above by any one of three means (or by any combination of them), namely (a) ring-fencing losses and/or (b) introducing a CGT and/or (c) introducing a land tax. As is explained below, a general CGT would be quite seriously problematic, whereas a land tax (meaning a tax on all land, excluding only the family home and perhaps Māori land) would deal directly with the problem and would also be simple, similar in its economic effect to a tax on capital gains made on land, and much cheaper to administer. The best course to take, therefore, would be to introduce a land tax (in conjunction with the two specific CGTs proposed above). Ring-fencing of losses would be at best a partial solution and it would also be problematic in several respects. In particular, it would be inequitable, complex and susceptible to avoidance. But even so, it might be a useful adjunct to a land tax.

Ring-fencing Losses

14. One aspect of the problem is that under the current law, landlords can not only deduct their operating expenses but also set off their operating losses against their other income. Many landlords take advantage of this by what they call "negative gearing". That is, they finance their acquisitions of houses by borrowing heavily – quite commonly up to 100 per cent of the cost of the house (which they can often do, despite the banks' lending restrictions, because they have other assets that they can use as security). Consequently, the interest paid to the lender (usually but not always a bank) exceeds the rent received from the tenant, so the landlord operates at a loss. Landlords usually also incur expenditure on rates, repairs and insurance, and these costs are deductible also.

15. A landlord suffering such a loss is permitted, under the current law, to set it off against his other income – meaning that he pays less tax on his other income than he otherwise would. For example, if he derives income from employment, he will be entitled to a refund of some of the PAYE withheld by his employer; and if he is self-employed, he will pay less tax on the income generated by his business. The losses suffered by heavily leveraged landlords are real, not artificial. That is, the landlord is genuinely suffering a loss, as a result of the large interest payments he is making to the lender. But landlords are commonly happy to put themselves in

this loss-making position, because the property market usually rises; and when it does, they will make a tax-free capital gain.

16. One way of dealing with this problem would be to amend the income tax legislation (currently the Income Tax Act 2007) so as to ring-fence landlords' operating losses. That is, landlords would still be able to deduct their operating expenses (interest, rates, repairs and insurance); but a landlord operating at a loss (because his total expenditure on interest, rates, repairs and insurance exceeded the rents received) would not be permitted to set it off against his other income. For example, he would not be entitled to a refund of PAYE. This would significantly reduce the degree to which the tax system currently subsidises investment in housing.

17. If a ring-fencing rule were to be introduced, it should permit the landlord to carry forward unused losses and set them off against future rental income. What often happens is that, over a period of years, the landlord's rental income goes up (because of inflation) while his interest payments remain unchanged (and go down, if he pays off principal). Consequently, he finds himself eventually operating at a profit; and at that point, he should be permitted to set off his accumulated losses (that is, the total amount of losses suffered in previous years, while he was operating at a loss) against his rental income. It would be possible to enact a rule *not* allowing the landlord to carry his losses forward, but it would be undesirable to do so for two reasons. First, it would be inequitable, in that *any* ring-fencing rule would disadvantage investment in housing as against other forms of investment; and to disallow the carry-forward of losses would be even more so. Secondly, it would be unnecessary. The problem is that landlords can currently offset their operating losses against other current income; there is no need to deprive them of their losses altogether.

18. Although ring-fencing landlords' losses would substantially redress the way in which the tax system currently subsidises landlords, it would be only a partial solution. The main reason for this is that capital gains would remain untaxed. Another problem, however, is that some landlords would attempt to get around the ring-fencing rule. Specifically, they would adopt arrangements aimed at *in effect* enabling them to set off their interest deductions against rental income, despite the rule. For example, an investor might own both a property portfolio and a share portfolio. Under the current law, he would typically use his own funds to buy shares and borrowed funds to buy houses. That way, under the current law, he could set his operating loss off against his other income. If a ring-fencing rule were to be introduced, he would use borrowed funds to buy houses only to the extent that the interest would be deductible – that is, the interest, plus the other expenses, would not exceed the rental income. But he could maintain the same level of debt as before, by using the surplus to buy shares. The result might be that he would now be operating his share portfolio at a loss; but the ring-fencing rule would not apply to share portfolios, so he would effectively be in the same position as before the rule was introduced.

19. In order to combat such arrangements, the ring-fencing rule would inevitably be complex and consequently expensive for the Inland Revenue to administer. Moreover, despite the complexity, it would still be far less than 100 per cent effective. Worse, it would generally be effective against less affluent investors (those owning only a small number of houses and without substantial other investments), most of whom would not be in a position to adopt arrangements such

as those described above; but it would be ineffective against richer and more sophisticated investors (who would be able to use arrangements such as those described above). In other words, it would be not only costly and ineffective, but inequitable and consequently perhaps politically problematic.

Land Tax and/or Capital Gains Tax

20. The Working Group has asked whether New Zealand should introduce either a CGT or a land tax (questions 2 and 3). The best course would be to introduce a land tax (plus specific CGTs, as indicated above) because that would be the best way of redressing the inequity and inefficiency built into the current tax system. A general CGT might also ameliorate the inequity and inefficiency, but a land tax (together with specific CGTs) would be better. The reasons are set out below, in the answers to questions 2 and 3.

21. The main benefits of a general CGT or a land tax would *not* include that it would make housing any more affordable, though it is possible that, at the margins, it would have that effect. The reason is that a CGT or a land tax would tend to deter investors from *buying* houses; it might consequently reduce demand for houses; and so the price of houses might fall. It is also possible, however, that a CGT or a land tax (or any other tax on developers or landlords) would deter investors from *building* houses – in which case the tax, far from ameliorating the problem, might aggravate it.

22. It is necessary to note also that any measure that deters investors from buying houses, although it might make houses somewhat cheaper to buy, might also drive up rents. The reason is that, if fewer investors buy houses, there will be fewer houses available to rent, so rents would be likely to rise.

Foreigners Buying Houses

23. It is widely thought that one of the reasons for the very high cost of housing is that a significant number of foreigners (that is, persons who are neither New Zealand citizens nor permanent residents) have bought houses here; and it has been proposed that the law should be changed to prevent them doing that. A better solution, however, would be to permit foreigners to buy houses but to tax them heavily if they do so. An example of a jurisdiction operating such a system is Hong Kong. There, a foreigner can buy a house (or, as is more common in Hong Kong, an apartment), but only on payment of a tax (called stamp duty) charged at 15 per cent of the purchase price: see Stamp Duty Ordinance 1981 (Hong Kong). The advantages of this system are that (a) it is not as inflexible as a total ban; (b) it presumably acts as an effective deterrent in most cases; and (c) in the relatively small number of instances where a foreigner buys a house (or an apartment), they are obliged to make a significant contribution to the public finances in the form of the tax. The tax is easy and cheap to administer and difficult to avoid or evade.

24. Hong Kong also generally does not permit non-residents to deduct interest incurred on funds used to purchase houses (or apartments): see Inland Revenue Ordinance 1947 (Hong Kong). Consequently, non-resident landlords are almost invariably liable for tax on rental income, irrespective of their level of debt. This rule, too, might be worth considering.

QUESTION 2

Should New Zealand introduce a capital gains tax (that excludes the family home)? If so, what features should it have?

25. There are strong arguments in favour of introducing a CGT, namely (a) equity and (b) efficiency. The equity argument is that equity requires that a person's liability to tax should be a function of his or her ability to pay; and that, all else being equal, a person who has made a capital gain is more able to pay tax than one who has not (assuming their incomes are otherwise equal). As one commentator observed, "A buck is a buck is a buck" – and it is irrelevant whether the buck is a capital gain or some other form of income: it should be taxed in the same way and at the same rate. The efficiency argument is that not taxing capital gains results in harmful distortions. Specifically, it incentivises people to arrange their affairs so as to produce tax-free capital gains rather than taxable income. More particularly still, it incentivises people to invest in land (mainly houses and apartments), rather than in something more productive, such as a business.

26. The better course of action, however, would be for New Zealand *not* to introduce a general CGT, but instead to introduce two specific CGTs (one on gains made by companies and the other on gains made on listed securities), plus a land tax. A general CGT might be better than nothing, but specific CGTs plus a land tax would be better still. The reason is that it is virtually inevitable that any general CGT would be seriously flawed.

Problems with a Capital Gains Tax

27. The first flaw is that it is probable that any general CGT would be charged at a lower rate than the income tax. In almost every country where there is a CGT, it is charged at a lower rate than the income tax. Usually, it is charged at about half the rate of the income tax: see Michael Littlewood and Craig Elliffe, eds, *Capital Gains Taxation: A Comparative Analysis of Key Issues*, Edward Elgar, Cheltenham, 2017. Similarly, when the Labour Party last proposed a CGT, the proposal was that it should be charged at 15 per cent. Such a tax (that is, a CGT charged at a lower rate than the income tax) might be better than nothing but it would be a long way short of ideal because it would leave both the equity problem and the efficiency problem largely unresolved.

28. Most importantly, taxpayers would still be incentivised to arrange their affairs so as to make capital gains (taxed at, say, 15 per cent) rather than ordinary income (taxed at 33 per cent, above a relatively modest threshold). The justification usually offered for taxing capital gains at a lower rate than other income is that it is a simple method of allowing for inflation. This line of reasoning is regarded by most economists as unsound, but by almost everyone else as unanswerable. It is one of the few strengths of New Zealand's current tax treatment of capital gains that, in the circumstances in which they are taxed, they are taxed at the same rate as the taxpayer's other income – that is, usually, 33 per cent (or 28 per cent in the case of companies); but it is unlikely that a general CGT would be imposed at 33 per cent. In contrast, it would seem to be both politically and technically feasible to introduce the two specific CGTs proposed here and to charge them at the same rates as the income tax. Similarly, an annual land tax could be set at a level that would result in approximately the same burden as the income tax, thus effectively redressing both

the inequity and the inefficiency of the current system. This is explained further below.

29. Secondly, the apparently universal experience of other countries is that CGTs are highly complex, so they entail much higher administration and compliance costs (per dollar of tax collected) than taxes on ordinary income. One reason for this seems to be that, in the nature of things, ordinary income tends to relatively regular, so administration and compliance are more or less routine. Capital gains, in contrast, are by their nature spasmodic and large. Consequently, the sale of a capital asset commonly gives rise to one-off difficulties and a powerful incentive to escape or minimise liability. There are also particular difficulties in calculating liability in the case of sales of shares in unlisted companies and interests in unincorporated businesses, and in the case of sales of land where improvements have been effected gradually over a period of years.

30. Thirdly, taxing a capital gain made on the sale of an asset situated in New Zealand is relatively straightforward where the seller is resident in New Zealand; but where the seller is not resident in New Zealand, it is often difficult and commonly impossible. For example, a non-resident might use a company incorporated in a country other than New Zealand to buy an asset (land or shares or almost any other kind of asset); and then, instead of selling the asset, he might sell the shares in the company (and so effectively transfer control of the asset to whoever buys the shares). If the tax were to be imposed on gains made on the sale of assets (which is the principal basis upon which most CGTs operate), no liability would arise. It is possible to legislate against such devices, but doing so is complex and inevitably only partially effective. Consequently, any CGT is likely to operate in practice as a tax on capital gains made by New Zealand residents; gains made on the disposal by foreigners of assets situated in New Zealand are likely to escape the tax. It is likely, too, that affluent and sophisticated New Zealand residents would be able to escape liability by entering into arrangements with non-residents. All this would be unsatisfactory in principle and presumably politically problematic.

31. Fourthly, the yield of a CGT is likely to be low, volatile and unpredictable. In itself that is a minor problem, given that the principal aims of a CGT would presumably be not to raise revenue but to correct inequity and inefficiency. (If the government were to introduce a CGT with the aim of substantially increasing revenue, it would probably be disappointed.) But even so, all else being equal, a reliable revenue stream would be an advantage. A land tax that exempted the family home should not produce any more revenue than a CGT (the land tax should be set at a rate calculated to produce roughly the same revenue as would be produced by a CGT); but what revenue it did produce would be stable and predictable.

32. Fifthly, it appears that the New Zealand economy differs from most points of comparison (for example, the Australian, British and US economies) in that (a) land constitutes a larger proportion of the New Zealand economy and (b) there are relatively more small landlords in New Zealand. For this reason, the compliance and administration burden (and probably also the political cost) of a general CGT would be higher in New Zealand than elsewhere.

Taxing Capital Gains Made on Sales of Listed Securities

33. Although CGTs are generally complicated, there is one category of capital gain that could be taxed quite simply: namely, gains made on disposals of listed shares and

other listed securities. That could be done by extending the definition of income (as provided for by the income tax legislation) to include such gains. Alternatively, it would be feasible to tax such gains on an accruals basis, though doing so would probably be more trouble than it would be worth.

34. It might be said that if capital gains made on the sale of listed securities are to be taxed, then *all* capital gains should be taxed; or, alternatively, that, if capital gains are generally not taxed, there is no reason for taxing capital gains made on the sale of listed securities. There are, however, strong reasons for singling out gains made on the disposal of listed securities for particular treatment. First, taxing such gains would be simple. Almost all of the complications from which existing CGTs suffer are due to rules dealing with other sorts of property – in particular, shares in unlisted companies, unincorporated businesses and land. Secondly, an important reason for not taxing gains made on sales of shares in unlisted companies (and sales of interests in unincorporated businesses) is that such an exemption can be justified as encouraging entrepreneurialism and small businesses. But that rationale obviously does not apply to listed securities.

35. If gains made on sales of listed securities were to be taxed, it would be appropriate for that to be subject to a *de minimis* exemption. The reason is that most New Zealand residents (including many of those who own shares in listed companies) are not currently obliged to file a tax return (because all the tax for which they are liable, including the tax on dividends, is collected by means of withholding); and to require persons making a small gain on the sale of shares to file one would entail a heavy burden in terms of compliance and administration.

Taxing Capital Gains Made by Companies

36. Similarly, taxing capital gains made by companies would be advantageous in principle (on the basis that capital gains ought generally to be taxed, unless there is some compelling reason not to tax them) and relatively straightforward in practice. Again, it would be feasible to tax such gains on an accruals basis, though, again, doing so would probably be more trouble than it would be worth.

The Working Group's More Specific Questions about Capital Gains Tax

37. In addition to asking the general question (Should New Zealand introduce a CGT and, if so, how should it work?), the Working Group asked a series of more specific questions about the design of a CGT (at page 55). These questions closely resemble those that Professor Elliffe and I put to the experts contributing to our recent book on CGTs (cited above). Consequently the book contains much information as to how other countries have answered more or less the same questions; and it can therefore be read as a guide on how to structure a CGT. The answers to the questions also seem to show, however, that a general CGT would be inescapably problematic – so the book can also be read as an account of the reasons for not introducing such a tax (and for introducing specific CGTs instead, as proposed above). In any event, the answers to the questions are as follows.

38. **Separate Tax or Part of Income Tax?** If the government were to introduce a CGT at all, it should be part of the income tax rather than a separate tax. The reason is that whichever form the tax takes, it would have to operate in conjunction with the income tax and that would be less troublesome if it were part of the income tax.

This is, however, ultimately a matter of mere labelling, rather than substance, and unimportant.

39. **Realisation or Accruals?** If the government were to introduce a general CGT, it should be based on realisation rather than accruals. The reason is that, whatever the conceptual attractions of an accruals-based tax, the practical difficulties would outweigh them. In particular, an accruals-based CGT would present heavy administrative and compliance burdens in the case of (a) small landlords, (b) shares in unlisted companies, and (c) interests in unincorporated businesses.

40. That said, it is necessary to add (a) that an accruals-based tax on gains on listed securities would be feasible; (b) an accruals-based tax on gains made by companies would probably be feasible; and (c) an annual land tax would operate as a very approximate proxy for an accruals-based CGT. In other words, the approach recommended here could be implemented in such a manner as to operate in effect as an accruals-based CGT – that is, no general CGT but an accruals-based CGT on gains made by companies and on gains made on listed securities, plus a land tax.

41. **Death?** If the government were to introduce a CGT, the best course would be for death to be treated as a disposal of the deceased's assets at market value. Alternatively, liability could be postponed until the person inheriting disposed of the asset (but using the deceased's basis to calculate liability). The US approach (simply exempting assets held at death from the tax) is obviously unsound in principle and highly problematic in practice.

42. **Relationship Property?** Conversely, in the case of a relationship property settlement, liability should be deferred until the asset is disposed of by the person taking it under the settlement. The difference is that death is usually a relatively convenient time to pay a tax; divorce etc is not.

43. **Scope?** The Working Group asks, if the government were to introduce a CGT, "[s]hould it cover just rental properties, shares, collectibles, private assets such as cars?" This question is curiously worded. New Zealanders commonly use the term "rental property" to mean residential property, but a general CGT would also ordinarily cover other sorts of real estate (commercial, industrial, retail, agricultural, horticultural, etc), whether rented out or not, and also holiday homes. Equally, whilst such a tax would ordinarily cover shares, it would also cover securities other than shares (debt instruments, derivatives, etc) and interests in unincorporated businesses. It would also cover collectibles. It is also usual and necessary for a CGT to incorporate provisions precluding taxpayers from using losses suffered on private use assets such as yachts and cars, which generally fall in value.

44. **Savings Schemes?** Consistency with the "broad based low rate" principle would require that savings schemes should be taxed, but an exemption might be desirable as an incentive to saving.

45. **Double Tax?** It would be obviously inappropriate to subject any particular gain to both income tax and CGT. Therefore, gains subject to income tax should be exempt from CGT. Dividends and capital gains made on shares are both forms of income; both should therefore, in principle, be taxed (subject to a preference for unlisted shares, as a means of supporting small businesses). There is no reason, therefore, why the introduction of a CGT should entail any change to the current imputation system. The introduction of a CGT might, however, require an adjustment to the FDR rules, so as to preclude double taxation.

46. **Non-Residents?** In principle, the jurisdictional scope of a CGT should be the same as that of the income tax – that is, residence and source, supplemented by CFC/FIF rules. In practice, taxation of non-residents would prove problematic (which is one of the reasons for not introducing a general CGT).
47. **Losses?** It would presumably be necessary to ring-fence capital losses, especially if the CGT were to be imposed at any rate less than the maximum rate of income tax and perhaps in any event.
48. **Roll-Over Relief?** If a general CGT were to be introduced, it would be highly problematic not to incorporate in it some form of roll-over relief (as illustrated by the Working Group's example of a farmer selling a farm and buying another). But other countries' experiences indicate that roll-over preferences tend to be excessively complex, inequitable and subject to abuse. The problems are so severe that they constitute one of the reasons for not introducing a CGT, but, instead, taxing specific classes of capital gains (gains made by companies and gains made on listed securities), and introducing a land tax.
49. **Death, Emigration, Immigration?** As indicated above, death should be treated as a taxable event, and likewise emigration. Similarly, immigration should be treated as establishing a basis where appropriate (in particular, in respect of assets situated outside New Zealand).
50. **Gifts and Gambling?** Similarly, it is obvious that gifts should be treated as a sale at market value (though perhaps with liability deferred until disposal by the donee). Not to have such a rule would leave the tax open to avoidance on a very large scale. It seems likely that the government is already deriving as much revenue as it can from some forms of gambling (for example, the TAB). To the extent that gambling winnings made by persons resident in New Zealand are not already subject to some appropriate tax, they should be subject to income tax (not CGT). Gamblers should not, however, be permitted to set off their losses against other forms of income.
51. **Rate of Tax and Inflation?** As indicated above, setting the rate (or rates) of a CGT is a conundrum. If the rate is set at anything less than the maximum rate of income tax, the CGT will fail to achieve its objectives of equity and efficiency. In particular, taxpayers would still be strongly incentivised to adopt arrangements designed to produce capital gains (taxable at a lower rate) rather than income (taxable at a higher rate). On the other hand, it is very widely believed that to charge the tax at the same rate as income tax would be grossly inequitable, unless some allowance is made for inflation. But no one has yet devised a satisfactory method of indexing a CGT for inflation. Again, this problem is one of the reasons it would be better not to introduce a general CGT but instead to tax certain classes of capital gains (those made by companies and on listed securities), and to introduce a land tax.
52. If a general CGT were to be introduced, however, a flat rate of about half the maximum rate of income tax might be the least problematic option – for example, 15 per cent. It would probably also be desirable to distinguish between short-term capital gains (taxable at the same rate or rates as ordinary income) and long-term capital gains (taxable at some lower rate, such as 15 per cent). Various countries do that; and they usually define "short-term capital gain" as meaning a capital gain made on the sale of a capital asset within 12 months of its acquisition. That seems, however, an unnecessarily narrow definition; it might be better (more equitable,

more efficient and less susceptible to abuse) to define "short-term capital gain" by reference to some longer period, such as five years rather than one.

53. It is unlikely that the government will find it politically palatable to impose a general CGT (other than on short-term capital gains) at the same rate as income tax. Rather, it would probably charge the tax at some lower rate. That in itself would constitute adequate allowance for inflation. The experience of other countries seems to be that there is no satisfactory method of indexing a CGT to actual inflation rates.

54. **De Minimis?** It might be advantageous to incorporate a *de minimus* rule in respect of both (a) small capital gains of all kinds made by non-filing taxpayers and (b) small capital gains made on collectibles by all taxpayers (that is, both filing and non-filing), other than companies.

55. **Administration?** The administrative and compliance costs of a general CGT would be substantial and, again, one of the reasons it would be better not to introduce such a tax. As alluded to above, the administrative and compliance burdens would probably be greater, proportionately, in New Zealand than elsewhere.

56. **Transition?** As regards the transitional arrangements on the introduction of a CGT, it is obvious that a general CGT should apply to all assets within the scope of the tax, whenever acquired; and it is also obvious that, in the case of assets held on the day the tax is introduced, the basis should be the value of the asset on that day. That is, the taxpayer should pay tax on the basis of the proceeds realised on disposal of the asset, less either (a) the cost of the asset (if it was acquired after the tax was introduced) or (b) the value of the asset on the day the tax was introduced (if the taxpayer acquired the asset before that day). Other relevant expenditure should be deductible also (for example, the cost of improvements).

57. The so-called Australian rule (that gains made on assets held on the day the tax was introduced are exempt, irrespective of when they are realised) is inequitable, inefficient (because persons holding such assets tend to retain them until they die) and complicated (because of difficulties caused by improvements made to such assets; and because of problems presented by schemes involving assets held by companies). The rule is, however, a good example of how the political process tends to produce seriously flawed CGTs.

58. **Trusts?** If the government were to introduce a general CGT, it should treat trustees in the same manner as other taxpayers – that is, disposals of capital assets by trustees (including disposals to beneficiaries) should be treated as a taxable event. It might also be necessary to enact rules dealing with the use of trusts to escape liability.

Conceptual Elegance versus Practicality

59. Some years ago, Chye-Ching Huang (a graduate of the Auckland University Law School and Columbia Law School, now working at a tax-oriented think-tank in Washington DC) and Professor Elliffe published an article arguing that the New Zealand government should introduce a general CGT unless it could be shown either (a) that there was something distinctive about the New Zealand economy (in which case the reasons CGTs were introduced in other countries might not apply in this one) or (b) that the countries that have introduced CGTs have all made a mistake: see Chye-Ching Huang and Craig Elliffe "Is New Zealand Smarter than Other Countries or Simply Special? Reconsidering a Realisation-based Capital

Gains Tax in the Light of South Africa's Experience" (2010) 16 New Zealand Journal of Taxation Law and Policy 269-305.

60. The answer to the question posed in the title to their article is, "Both". That is, first, New Zealand is "special" or, at least, different, in that (a) land plays a larger role in the economy than in some other countries; and (b) there is a larger number, proportionately, of small landlords than in some other countries; and (c) the stock market plays a smaller role in the economy than in some other countries; and (d) there is perhaps a stronger case in New Zealand than elsewhere for incentivising entrepreneurialism.

61. Secondly, it may be that the governments of other countries were seduced by the conceptual elegance of the Haig-Simons concept of income; and that they failed to fully appreciate the difficulties that would arise in connection with their attempts to tax capital gains made on (a) unlisted securities, (b) interests in unincorporated businesses and (c) houses; and that they failed also to appreciate the difficulties and complexities that would result from the interactions between (a) their attempts to tax capital gains of these kinds and (b) their desire to provide for roll-over relief and incentives for small businesses and (c) political pressures and compromises.

62. In conclusion, the supposed elegance of general CGTs based on the Haig-Simons model has in most countries turned out to be largely illusory – mainly because of the difficulties encountered in connection with family businesses (both incorporated and unincorporated), farms and houses. The approach suggested here – specific CGTs on capital gains made by companies and on gains made on listed securities, plus a land tax – might be less conceptually appealing; but it would be much simpler and it would ultimately achieve much the same result. It would also have the advantage that the two specific CGTs could be charged on an accruals basis; and the land tax would similarly be charged annually.

QUESTION 3

Should New Zealand introduce a land tax (that excludes the land under the family home)? If so, what features should it have?

63. For the reasons outlined above, a general CGT, although probably better than nothing, would be problematic. A land tax (together with specific CGTs, as outlined above) would be better. It would, if correctly designed and set at an appropriate rate, largely eliminate both the inequity and the inefficiency of the current system. It would also be straightforward and inexpensive to administer; it would be inexpensive for taxpayers to comply with it; and it would be difficult to avoid or evade. The simplest way for such a tax to work would be for the central government to impose a tax on top of local government rates, using the same valuations as are used for rates, but exempting "the family home". That is, the tax would be imposed on all owners of land and buildings, but every family would be entitled to an exemption in respect of its "family home". In other words, the family home would be exempt but the tax would otherwise be payable on real estate of all kinds (residential, commercial, industrial, retail, agricultural, horticultural, etc) and also on holiday homes (except where the holiday home was the owner's only home). It might also be appropriate to exempt Māori land, or some classes of Māori land.

64. One of the disadvantages of a general CGT is that it would require both (a) the keeping and verifying of records over very long periods of time and (b) the undertaking of retrospective valuations of assets, in some circumstances long after the event. A land tax would present no such difficulties, because it would be based simply on current valuations (which are maintained already, for local body rating purposes).

The Rate of Tax

65. At what rate, then, should a land tax be charged? That is a difficult question, but the objective should be to set the tax at a rate that would neither advantage nor disadvantage investment in real estate. For example, an appropriate rate might be 0.25 per cent. Thus, the tax on a house worth $1 million (including the land on which it was built) would be $2,500 per year. That might seem too low, especially in light of the very large capital gains made on residential real estate in the last few years. But the land tax would be payable every year; it would be payable in addition to the income tax imposed on the rental income (if any) derived from the land; and it would be payable even if both (a) the property market was flat or in recession (in either of which cases the owner would not be accruing any capital gain) and (b) the owner was operating the property at a loss (because of interest deductions).

66. It is possible that the introduction of a land tax, even at a low-seeming rate such as 0.25 per cent, would cause a substantial fall in the property market. In other words, it is possible that a large part, or even the whole, of the burden of the tax would in effect be borne by those owning property at the date the tax comes into force. For this reason, it is possible that it would be preferable to introduce such a tax by degrees – that is, to introduce it at a very low rate (say 0.1 per cent) and to raise the rate gradually over time.

67. It would be possible to provide either for the land tax (if one were to be introduced) to be deductible for income tax purposes or not deductible. If it were to be deductible, it should be charged at a higher rate so that, in either case, the burden would be roughly the same as would result from taxing the capital gain.

Farming and Horticulture

68. It is possible that the objective (neither advantaging nor disadvantaging investment in land) would be best achieved by providing for different rates of tax for different kinds of land. In particular, the appropriate rate for commercial, industrial and residential land might be unduly burdensome for agricultural and horticultural land, in which case such land should be taxed at some lower rate. The objective, however, should remain the same – that is, investment in farmland should be neither advantaged nor disadvantaged, as against other forms of investment and income.

69. It is possible also that some farmers would object vehemently to a land tax at any sensible rate. One solution to that problem would be for the law to give them a choice: either pay the land tax, or pay income tax on the gain made on sale.

Māori Land

70. Imposing a tax on Māori land would seem to be both problematic as a matter of policy and technically difficult. The best solution might be simply to exempt Māori land (or some classes of Māori land) from the tax.

QUESTION 4

What are the main opportunities for effective environmental taxation?

71. There are two main opportunities for effective environmental taxation in New Zealand, namely (a) a tax on emissions and (b) a tax on cars (but with an exemption for small cars).

Taxing Emissions

72. It seems reasonably plain that emissions trading schemes, including the one currently in force in this country, are ineffective and susceptible to abuse. It is probable, therefore, that a better approach would be to tax emissions, including those produced by farming. It is crucial, however, that, if an emissions tax were to be introduced, it should exempt exports because (a) in principle the tax should be borne by consumers, not producers and (b) to tax exports would be to impose a competitive disadvantage on the New Zealand economy. An emissions tax would, therefore, have to incorporate some kind of border adjustment mechanism. It is currently unclear how such a mechanism might best work; further research is therefore required.

Taxing Cars

73. A large part of New Zealand's contribution to climate change comes from motor vehicles, particularly cars. The best way to mitigate this problem would be to tax them heavily. Given, however, the parlous state of public transport in most parts of the country, a car is for most families a practical necessity. A heavy, general tax on cars would therefore be unacceptably regressive. Many people, however, have cars which are much larger and which use far more fuel than necessity requires. The appropriate course, therefore, would be to impose a heavy tax on cars, but subject to an exemption for electric cars and cars that use relatively little petrol or diesel.

74. Various other jurisdictions, such as Singapore and Hong Kong, have used taxes of this sort with considerable success. They persuade many people to buy small, fuel-efficient cars, and they derive a more appropriate level of revenue from those who are prepared to pay the tax to drive large, inefficient vehicles.

QUESTION 5

Should the tax system do more to support small businesses? In particular, is there a case for a progressive company tax?

75. It is arguable that the profits of small businesses should be taxed less heavily than other forms of income, so as to encourage entrepreneurialism. The existing tax system already taxes small business less heavily than salaries and wages, in that there is no general CGT. Consequently, if an entrepreneur builds up a business and then sells it, the gain is usually tax-free. If a general CGT were to be introduced, that would no longer be the case – assuming the CGT would be so structured as to catch such gains (some CGTs provide for relief in such circumstances). But if the government were to take the approach proposed here (introducing specific CGTs on gains made by companies and gains made on listed securities, plus a land tax, rather than a general CGT), capital gains realised on the sale of a business would

remain generally untaxed, as under the current system – which is another reason why the approach proposed would be better than a general CGT. This system would in itself provide sufficient support for small businesses, so nothing further (such as a progressive company tax) would be needed.

76. To this it might be added that the tax on small businesses is, in effect, progressive already, because a company carrying on a small business usually employs some of the members of the family that owns it; the company is entitled to deduct the salaries and wages paid; and the salaries and wages are taxed at progressive rates. Consequently, for practical purposes, the existing system in most cases already taxes the profits of small businesses at the same progressive rates as are applied to other forms of income (such as salaries and wages).

77. Moreover, the profits of small businesses are already in effect taxed *less* heavily than salaries and wages, in that (a) the current law does not permit the deduction of expenditure incurred in connection with employment income, and (b) the tax treatment of perks under the present system is not watertight. That is, the owners of family companies and other small business are often able, quite legitimately, to deduct the cost of expenditure on items conferring an element of personal benefit, without giving rise to any liability to personal income tax or fringe benefit tax. Wage and salary earners do not have that advantage.

QUESTION 6

Should the tax system exclude some goods and services from GST? If so, what should be excluded? What else should be taxed to make up for the lost revenue?

78. It would be a serious mistake to exclude any goods or services from GST (other than those already excluded). The reason is that New Zealand's GST is currently the best value-added tax in the world; and what makes it better than any of the others is precisely that it currently has very few exclusions. Any added exclusions would make it a worse tax than it currently is because (a) they would fail to achieve their intended objectives and (b) they would introduce a wholly disproportionate degree of complexity to the legislation and to the administration of the tax; and (c) they would incentivise a range of undesirable behaviours on the part of suppliers of goods and services.

79. Most other countries' value-added taxes have what might be called "policy-driven" preferences. For example, they have exclusions for basic foodstuffs, basic medical treatments and basic educational goods and services. The New Zealand GST system, in contrast, has no such exclusions. Rather, the only exclusions in the New Zealand system are there for purely technical reasons. In particular, residential rent and financial services are exempt. The reason for these exemptions, however, is not to give preferential treatment to housing or financial services. Rather, the only reason for them is that it would be technically difficult to tax them.

80. It is appalling that many people in New Zealand cannot afford to eat healthily, to obtain basic medical services and to educate their children properly; and it may well be that the government should take steps to address such problems. It does not follow, however, that excluding goods and services of these kinds from GST would be desirable. There are four main reasons.

81. First, excluding these goods and services from GST would make only a small difference to their affordability, so would be unlikely to solve the problem.

82. Secondly, the largest savings in tax would go not to those who cannot afford the goods and services in question, but to those who spend most on them. In other words, such preferences would mainly go to people broadly classifiable as upper middle class or rich.

83. Thirdly, even if it were to be accepted that it would be desirable to in principle to provide preferential treatment for certain classes of goods or services from GST, it would be difficult to define the scope of the preference. For instance, it has been suggested that fresh fruit and vegetables should be excluded from GST. It appears, however, that frozen and canned vegetables are at least as nutritious as fresh ones, and typically cheaper. Thus, the call for a tax preference for fresh fruit and vegetables seems less like a policy aimed at helping the poor and more like a subsidy for the middle class and the rich, who mostly prefer fresh vegetables to canned and frozen ones.

84. Fourthly, excluding specified classes of goods and services from GST would encourage gaming of the system by some suppliers of goods and services. For example, the GST system could be modified so as to exempt (or zero-rate) supplies of bread, whilst still taxing supplies of cake. The consequences would likely include that manufacturers of some border-line products (croissants, brioche, etc) would modify their recipes, so as to have them classified as bread (and thus escape the tax). See, for example, *Revenue and Customs Commissioners v Procter & Gamble* [2009] EWCA 407, in which the Court of Appeal of England and Wales held that pringles (a kind of synthetic potato chip) were not entitled to a VAT preference intended for basic foodstuffs.

85. If the government were to decide to take steps to ameliorate the unaffordability of certain classes of goods and services (such as basic foodstuffs, basic medical goods and services and basic educational goods and services), it would be much better for that to be done by means of a subsidy, rather than by excluding such goods and services from GST. The reason is that it would be both cheaper and more effective.

86. It is widely thought that granting a tax concession (such as excluding fresh fruit and vegetables from GST) would cost the government less than a subsidy. This is, however, incorrect. The reason is that a subsidy could be directed to those who need it – that is, people whose incomes are too small to allow them to feed themselves adequately. That could be done by any measure that would raise small incomes generally or by more specific measures, such as, for example, issuing vouchers redeemable for vegetables. The benefit of a GST preference, conversely, would be unavoidably available to everyone, and would mostly go to people who did not need it. Moreover, if the government were to subsidise vegetables for people on small incomes, it could control the amount of its spending, whereas the revenue loss resulting from a GST preference would be beyond the government's control.

87. It might be said that for the government to give vegetable vouchers to poor people is unduly paternalistic; and that poor people, like everyone else, should be allowed to spend their money on whatever they like. There is much force in this argument, but to issue vouchers for vegetables is no more paternalistic than to grant a GST exclusion.

88. It is possible that GST is regressive (though the question seems to be under-researched; it is also possible that the non-taxation of residential rent and interest substantially mitigate the tax's regressive effect). But even if it is regressive, it would be a mistake to attempt to solve that problem by means of exemptions. A better solution would be to accept that GST is regressive and to increase the overall progressivity of the tax system by reducing the income tax burden on small incomes (and, if necessary, raising transfers). That way, although GST would remain regressive, the overall progressivity of the tax (and transfer) system could be set at whatever level the government thought appropriate.

SUGARY DRINKS TAX

89. The Working Group has asked whether the tax system should be used to encourage desirable behaviours or discourage undesirable ones. The answer is that it should. In particular, it would be advantageous to tax sugary drinks (so as to discourage their consumption), both as a health measure and to reduce the extent to which consumers of excessive quantities of such drinks impose a burden, through the publicly funded health system, on other taxpayers: see generally Michael Littlewood "Taxing sugary drinks" 2016(11) New Zealand Law Journal, 422-424. There are four main arguments against such a tax but none of them is sound. The four arguments and the flaws in them are as follows.

90. The first argument is that a tax on sugary drinks would constitute an inappropriate interference with individual freedom of choice. In other words, people should be free to make their own choices, without the state acting as nanny. But we already have a nanny state and no one sensible suggests that the state should stop nannying us. For example, we have a law banning you from riding a motorcycle without a helmet; a law requiring you to wear a seatbelt in a car; and laws requiring you to wear various kinds of protective clothing in various kinds of dangerous workplace. These are nanny-state laws, but very few people seem to think it would be a good idea to repeal them. The real question, then, is, not *whether* the state should act as a nanny, but *when* (that is, according to what criteria?) and *how* (that is, by what means?).

91. The answer to the first question (when should the state intervene?) is that the state, in determining whether to protect us from ourselves, should consider two criteria. First, how harmful is the product or activity to the person who uses it? Second, how expensive are the consequences of the product or activity for the rest of us? For example, the taxes on liquor and tobacco can be justified on the basis that these products are harmful to those who use them; and that the revenues generated by the taxes go some way towards meeting the costs of medical care borne by the state (and, perhaps, other expenses). Similarly, the requirement that you use a helmet and a safety belt are justified on the basis that not using a helmet and a safety belt is dangerous for the individual and expensive for the state. The answer to the second question (if intervention is called for, should it come in the form of a tax or some other measure?) is that the intervention should take whatever form is most likely to work and to produce least undesirable side-effects.

92. Judging by these criteria, a tax on sugary drinks is easy to justify. First, the harm to the individual resulting from excessive consumption of sugary drinks seems comparable to the harm resulting from excessive consumption of liquor or tobacco.

Secondly, the cost to the taxpayer attributable to excessive consumption of sugary drinks is also comparable to the cost attributable to excessive consumption of liquor or tobacco. In fact, the cost of sugary drinks seems to be greater than the cost of liquor or tobacco.

93. The second argument against a tax on sugary drinks is that it would fail to achieve its objective. It might be the case that some other countries' sugary drinks taxes have had little effect but, if so, that is because they have not been charged at a high enough rate. An appropriate rate might be, for example, a dollar per litre (on drinks containing more than a threshold quantity of sugar per litre).

94. The third argument against a tax on sugary drinks is that it would be inappropriately regressive. But that is not so, because the tax would incentivise manufacturers to produce a wider range of drinks containing other (untaxed) sweeteners (which, according to most medical opinion, are less hazardous to health than sugar). In fact, some manufacturers already produce such drinks (for various reasons, including the possible introduction of a tax). Consequently, the tax would be effectively optional: anyone not wanting to pay could avoid doing so by buying drinks sweetened with ingredients other than sugar.

95. The fourth argument is the blanket assertion that taxes should not be used to encourage desirable behaviours or to discourage undesirable ones; and that the government, if it wishes to encourage or discourage, should uses means other than taxes – such as education or regulation. This however is not really an argument but an ideology; whether a tax should be used as an incentive or a disincentive in any particular case should be assessed by reference to factors relevant to that case, not by mere assertion.

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