Tax Working Group Public Submissions Information Release

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Submission to Tax Working Group

Submissions on Appendix 2: Design Issues With a Capital Gains Tax

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Personally I don't favour a comprehensive capital gains tax, however, recognising that consideration of one is core part of the TWG's brief (and that certain members appointed to the TWG are publicly known to support one) I have following comments to the questions raised about the design of one in Appendix 2.

(1) Should CGT be a separate tax or part of income tax?
Submission: Best part of the income tax regime as it will enable better integration with existing income tax regime and the boundary that must be determined between income and capital gains provisions.

Big Issue: How such capital provisions if introduced will stand under New Zealand's existing double tax treaty network. Whether taxing capital gains is a tax on income or on capital could be important in litigation under existing double tax agreements.

(2) An accruals based CGT is totally impractical and is not found elsewhere (other than one attempts by NZ earlier with its FIF rules - not a good experience). It must be realisation based for liquidity reasons and also that objective and accurate prices will be on hand to enable precise assessment without undue compliance/administration costs.

Using realisation as the point of assessment will lead to the "locked in" effect. I strongly advocate a comprehensive roll-over regime not just for business assets but within investment portfolios. This will reduce this "locked-in" effect and also enable taxation to be levied when capital gains are used for consumption purposes.

Rollover on death and matrimonial settlements is essential as there will be liquidity problems otherwise for taxpayers. Family farms and businesses would be vulnerable.

(3) A comprehensive capital gains tax should be a as broad as possible as a trade-off for a lowish flat rate to apply (15% has been previously advocated by Labour at prior elections). I believe the tax should not be limited to a range of transactions that are likely to give rise to capital gains but to better approximate the genuine "capital" type return a taxpayer enjoys/suffers. Why should taxpayers be liable to CGT on a sale of shares but not be able to deduction a loss of loan principal when a bond issuer defaults? Ultimately for enforcement and administration reasons are practical limits how far a CGT can be

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extended especially when asset ownership is not formally registered (as is with land and shares etc).

An unintended effect of a residential home exemption in Australia has been “land banking” of the taxpayer’s residence or the incentive effects of using one’s own home as an investment vehicle over other types of more productive investment because of the tax exemption. I believe the residential home exemption to be limited to sales of homes below a certain value (revised regularly) and above that the gain be apportioned between exempt and CGT.

Kiwisaver (PIE) tax rules already have a preference for capital gains that are not available to other taxpayers. Continuing with it may have some merit to enhance the attractiveness of saving through Kiwisaver. Very few tax preferences currently exist for retirement saving in New Zealand.

(5) Offshore assets be subject to CGT? To maintain consistency, equity and to avoid artificial incentives to invest offshore would suggest that they be subject to the same rules. But those falling under the FIF rules they should be removed from their scope to avoid double taxation.

(6) FIF rules, imputation, land rules, CFC rules. Big decisions will need to be made here. The key issue to me is if a CGT is to be designed with any *integrity*, the current ITA needs to be comprehensively reviewed to find all those transactions which on common law principles would be regarded as producing capital gains but have by legislative intervention been deemed to be assessable ordinary income.

The major ones:

- Land sales - the rules currently found in sec CB 6A to CB 23B ITA 2007 do tax what are in essence genuine capital gains. Long-term subdivision schemes are probably the worst affected. I believe that long-term effect of these rules has been to increase the price of subdivided land since investors in those schemes require a substantial pre-tax return to overcome the tax burden applying to holding gains (largely due to inflation). Interestingly these rules were first introduced in 1973 allegedly to improve housing affordability when in fact they are probably undermining it (!)

- Financial arrangement rules also need revision – they are obnoxious in that they lack transaction symmetry, gains taxable but losses arising the same situation are not necessarily deductible. These affect non-corporate portfolio investors primary where FAs are denominated in foreign currencies. The denial of a deduction for loss of loan principal when the taxpayer is not carrying on a business of dealing in FAs should also be addressed in a CGT regime.

- If comprehensive CGT is introduced, there can be a case mounted to repeal the FIF rules or severely restrict their application to unusual types of interests where substantial deferral may occur.

Imputation – under a CGT gains made are more than likely to attract a tax preference vis-à-vis ordinary income. Should that preference pass through to company shareholders under imputation? If so, should it be restricted to resident investors or non-resident as well (DTAs will affect this too). I believe that CGT preferences should be passed through to shareholders – there is a precedent for this with the R&D credit offered in the mid-2000s.

Non-residents should be subject to CGT if assets are situated/located in New Zealand. On practical grounds, portfolio trading of shares in NZ resident companies has to be outside the CGT net which is consistent with international practice.

(8) If capital gains are to be taxed preferentially then they have to be quarantined. Another possibility might be to allow them to offset against ordinary income the same year incurred but using a discount factor or converting them into a tax credit against an ordinary income tax liability.

(9) Comprehensive rollover should be provided and not just limited to capital assets for the carrying on of active businesses. One of the disadvantages of a realisation based CGT is the locked in effect where taxpayers defer selling an asset they would otherwise wish to sell because of the tax crystallising on sale. This is particularly so when the asset has been owned for a long time. It also stands in the way of reallocating portfolios in a more optimal way. By allowing rollover within a portfolio provides neutrality between selling and holding (realised vs. accrued gains) and taxation when the gains are realised for consumption are more appropriate and consistent with other types of income earned.

(10) Gains at death should be rolled over to prevent liquidity problems in respect of gains made on assets not easily realised (or partially realised) e.g. family farms. Emigration and immigration issues would assumedly be dealt with using the usual residence/non-resident classification. If a class of NZ situated assets held by non-residents are outside the CGT (portfolio equity shares) then the issue arises of a deemed disposal – an option could be offered for New Zealand citizens to defer recognition of CG for a certain period after they become non-resident to allow for the prospect that they may become resident again a few years later.

(11) Gifts should be left outside the CGT net. They are not capital gains.

Major gambling and lottery wins should be subject to CGT. Why should gambling be tax preferred over long-term investment? A deminis exemption should apply ($50,000?) and beyond a certain level a standard % deduction in recognition of the likelihood of gambling losses been previously incurred. A source deduction by the gaming operator should be adequate – maybe as a final tax. This does the leave the problem of large wins by non-residents. The US may be able to provide som drection

(12) Tax rate – the answer to this links to how the gain is calculated. If done on a straight historical cost basis, then a flat low rate would have to be offered - the Labour Party had previously mentioned 15%. The problem with the flat rate is that it would over tax low income earners on CG but would be much more concessional for higher earners. A better approach might be to tax only half the gain derived but at ordinary income tax rates. That would preserve the concessional treatment no matter what other income the taxpayer had. Taxing half would also act as an inflation adjustment without high compliance costs.

(13) Adjustment for inflation – I don't favour indexation for inflation as was initially offered in Australia with their CGT. It leads to high compliance costs. It would be much easier

to tax half the nominal gain at the taxpayer's marginal tax rate as Australia currently does.

(14) A deminimis rule might have some advantages of targeting the CGT towards higher earners allowing a tradeoff between compliance and administrative costs. It would necessitate taxpayers keeping accurate records and that may be problematic. Canada at some stage had a life time exemption - how practical that proved I am not certain.

(15) The provisional tax system is totally unsuited for paying tax on irregular amounts of income, the same would apply for CGT. There would have to be a simple way of paying CGT for isolated sales. Perhaps an option of paying directly by the taxpayer 3 months after realisation with a CGT return filed at the end of the year unless taxpayers wanted to use the provisional tax system.

Revenues raised by CGT needs to be recorded separately so that revenue officials can identified how much is raised each year. CGT can be a volatile revenue source for a government and the usual risk is that a government uses windfall CGT receipts when markets are booming to fund spending programmes which are ongoing and long-term creating deficits when the CGT windfall ceases.

Mandatory reporting and withholding taxes (other than the existing ones on land sales) should be avoided as the costs will passed on and end up being borne largely by small investors whose CG may be very small.

(16) Transitional arrangement are extremely important. Any government contemplating a successful introduction of a CGT should be prepared to have concessional or generous transition arrangements which may cost revenue short-term but result in a much fairer and more acceptable system:

Exempting assets owned prior to CGT introduction as in Australia is not a good option as it creates a gigantic locked in effect and sometimes perverse outcomes. For example, a property investor there can avoid CGT by renting out their existing home which was acquired prior to the introduction of CGT as a personal residence and buying a new property for renting out. If the original house is retained for personal occupation and the new property rented out, then CGT is liable. This seems very arbitrary.

Using original cost would penalise those who have accrued large gains on assets held long term prior to the introduction of CGT probably leading to a mass stampede of selling around the time CGT would be introduced. Alternatively using market value at time the CGT was introduced could lead to over taxation. The only option to me is to allow the *higher* of original cost or MV at the time of introduction of the tax. Proxies for MV would have to be allowed for where historical cost is not easily ascertained. These should be done on a relatively generous basis.

(17) Obviously assets held by family trust would need to be included in the CGT net. It is essential though that the treatment of trust assets should be no worse than assets directly held by an individual. Distribution of trust assets to a beneficiary should be on a roll over basis and not a deemed disposal.

> It needs to be borne in mind that trust can be used as a way of deferring recognition of CGT on long-term assets within a family. This has led some countries (Canada?) to have rules of trust assets been subject to deemed disposal every 20 years to prevent excessive deferral. I don't favour such a rule but it indicative of the sort direction a "simple" capital gains might end up leading to significant complexity and compliance costs. (It will not be very popular with voters given the large number of holiday homes in New Zealand owned by family trusts.)

Some warnings also need to be given to legislators about CGT:

If a CGT is introduced in New Zealand, there will inevitably be embarrassing cases where non-residents are exempt from the CGT due to existing DTA obligations. This occurred in Australia and South Africa when they introduced CGT. It is difficult for politicians to explain to the general public why a wealthy non-resident or multinational corporation does not have to pay CGT when a New Zealand resident pensioner might have to.

Much has been made of an alleged link between CGT and housing affordability. The 1973 Labour Government made great stock of introducing penal tax provisions for certain land transactions only to leave home buyers disappointed that the measures did not appear to improve assist housing affordability. A comprehensive CGT in Australia has not assisted housing affordability there. As long as capital gains are tax preferred over ordinary income, there is no reason to suspect an introduction of a CGT will reduce incentives to invest in rental properties. The proposed loss quarantining is potentially much better. On the other hand if a CGT was selectively imposed on land transactions but not other asset types, over investment in property could be discouraged although policing it could be difficult i.e. 'land rich' companies.