Tax Working Group
Te Awheawhe Tāke

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Dear Sir

Submission

This is a submission by Olivershaw Limited to the Tax Working Group. One of the directors (Robin Oliver) of Olivershaw Limited is a member of that Tax Working Group. He was not in involved in this submission.

Executive Summary

This submission covers the following key topics:

1. Tax Settings
2. Capital Gain Tax
3. If taxes need to be raised, how is this best achieved
4. Policy setting process – GTPP
5. Other issues the TWG could suggest where the government undertake further work to improve the overall tax settings.
6. Other issues The TWG should not make any comment on as they are regimes that are working extremely well

Overall, I believe that the fundamentals of the tax settings are about right. Theoretically before working through the detail, I see there is a case for a capital gains tax (CGT). When you consider the design issues, including the exemption for the family home, exemptions for most non-resident investment into New Zealand, and the considerable increase in compliance costs, I do not see net gains from introducing a comprehensive CGT.

That said, I am concerned that with residential rental market the current supply related issues have resulted in many expected capital gains that taxpayers are taking this into account when making such investments. This capital gain is reasonably expected and, like what happened with international portfolio shares, was correctly seen as under taxation. I caution any immediate policy change as should the supply issues be corrected, the commercial settings where rental income should be a market return without capital gains could occur again. If the capital gain continues to be a necessary feature of that investment, consideration should be given to whether a fair dividend type regime should be imposed on residential rental. I think this is a better result compared with a realised CGT. Also regard should be given to the loss ring-fencing rules and changes to the bright line tests that have been announced as that may correct the tax issues with these investments.

1 Tax setting

New Zealand has a very good tax system, the tax settings have been reasonably stable, there are few distortions and has operated very well, especially through abnormal external events such as the global financial crisis. From a practitioner's perspective the key aspects of NZ tax settings can be summarised as follows:

- Very few distortions
- Very predictable
- Reasonably simple
- Low compliance costs.

Having a tax regime that has very few distortions and is very predictable by default means that it is simple and this keeps compliance costs low. When taxpayers undertake transactions that require tax advice, in most situations the answer can be predicted without looking up tax legislation, this is ideal from a tax advisers and taxpayers perspective.

In particular, we note the following features of the NZ tax system that increases predictability and lowers compliance costs;

- Having reasonably flat income tax rates and having close alignment between the corporate rate with the trustee/individual tax rates. Clearly if there was total alignment then several pressure points point would disappear.
- Having the imputation regime to ensure, however a taxpayer earns income, there is simply one level of tax regardless of what commercial structure is applied by that taxpayer. Consistent with the above point, the lower corporate rate provides an incentive to use the corporate structure given the lower tax rate where income exceeds $48,000 (where the individual rate is 30%)
- Not having a capital gain tax regime – these regimes add considerable complexity with considerable non-intuitive boundary lines and rules which ultimately end up in raising compliance costs.

I am most concerned with the international settings and that is the focus of our submission in this section.

By way of background, Olivershaw has recently assisted with taxpayers investing and residing in European countries and Australia. The tax regimes in these countries can be summarised as having many distortions, very unpredictable and therefore requiring detail advice and careful planning. This leads to considerable complexity and considerable compliance costs. Worst, given these complex regimes, it can be difficult for taxpayers to correctly price and forecast tax when taxpayers are making investment decisions. This can lead to situations when investment, especially when bidding for assets against other investors, becomes uncompetitive. This is the worst outcome from a complex tax regime.

New Zealand since the 1980s has generally changed the international tax setting to ensure lower taxes on foreign investment and increase certainty. This has obvious benefits when attracting foreign capital to invest in New Zealand. New Zealand requires foreign investment to fund investment in business to further grow GDP and create more employment. Until recently the international settings have been stable and predictable. More recently this cannot be said of our international settings. Officials have progressively made changes to existing boundaries to effectively collect more tax on foreign investment into New Zealand. This approach has the following implications:

- It increases taxes on non-residents; and
- It reduces certainty and predictability for non-residents.

The above simply means that when non-residents invest into New Zealand, they increase the risk weighting they place on New Zealand investments. This, in the margins, will result in some foreign investors not investing in New Zealand and those that do invest requiring a higher rate of return or higher interest rates on their New Zealand investment.

In my view there is a fine line between making changes that simply increase taxes and those which have solid policy foundations. This is an area of judgment, there is no objective test. The current direction is that officials keep changing the existing settings to collect more tax.

Examples where officials have changed the international settings to collect more tax include:

- Reducing the thin capitalisation debt to asset ratio from 75% to 60% (there was an offsetting adjustment with a lower corporate tax rate of 28%)
- Micro changes to remove assets from the definition of assets, thus having the effect of requiring more equity and less debt to be invested in New Zealand
- Changing the basis of gross assets to net assets (gross assets less non-interest-bearing debt) - this is a micro change but significant change to the thin capitalisation settings requiring significant more equity to be invested by non-residents to avoid non-deductible interest
- Reducing the ability for foreign investors to use approved issuer levy (2% tax on interest payments) and use NRWT rates (10% plus)
- The proposed hybrid tax changes
- The proposed interest rate cap changes
- Extending transfer pricing in relation to interest to shareholders to apply more widely than taxpayers that are associated.

In my view, sophisticated foreign investors that make direct investment into New Zealand undertake a considered and comprehensive review of all the international settings. This includes the corporate tax rate, but more important is the thin capitalisation regime, transfer pricing regime and certainty of the tax settings. The corporate tax rate is not as important as the other settings. In this regard, New Zealand is more appropriately considered as a jurisdiction that is increasing taxes and complexity on non-residents. Worst, when advisers are asked by non-resident investors on the stability of these settings, the above list demonstrate the direction of reform.

I contrast the above changes with what many countries are doing to their international settings. Many countries are following the OECD BEPS reforms to reduce hybrid instruments however to offset the increased taxation from this, they are significantly reducing their corporate tax rate. New Zealand is simply doing the changes regarding hybrid instruments without any offsetting reduction.

I recommend a process is implemented to take an overall review of the settings and how we compare with what other countries are doing.

2 Capital Gain tax

There are three approaches to introducing a capital gains tax, namely:

- A comprehensive CGT including the family home (albeit outside the terms of reference for the TWG)
- A comprehensive CGT excluding the family home
- Changes to the existing capital revenue boundary to address areas of concern.

The first point to consider is whether New Zealand needs a CGT. Then consideration should be given whether the CGT that would be enacted will address the reasons why there should be a CGT and whether this is an improvement given the compliance costs that will arise.

Do we need a CGT?

Whether we need a CGT an important consideration. The TWG March 2018 report noted the following:

- it has been argued that our current tax rules (and in particular the lack of tax on rental property gains) may have contributed to unaffordable housing. (page 46)
- Under a broad-based, low-rate system, ideally the bars in Figure 21 would line up perfectly and <u>there would be no difference in marginal effective tax rates between the types of investments</u> (page 39, emphasis added – implying that a lack of a CGT distorts investment)
- The Government has established the Tax Working Group (the Group) to examine further improvements to the structure, fairness, and balance of the tax system (page 3)
- Revenue integrity: minimise opportunities for tax avoidance and arbitrage (page 4)
- The Group is keen to hear public views on the overall performance of the tax system, and has a particular interest in assessments of the fairness and balance of our tax settings (page 6)

In addition, over the years various comments have been made by officials and private sector for the need for a CGT. These comments can be summarised as follows:

- Dividend stripping structures where taxpayers have avoided paying tax on corporate profits that are only taxed at 28% as opposed to 33% - the proposed solution to this is a CGT
- Taxpayers can restructure their affairs so they receive capital receipts as opposed to taxable receipts (excluding the dividend stripping opportunities as discussed above)
- A lack off a CGT distorts taxpayers investment decisions into asset classes that produce untaxed capital gains
- There are subjective rules whether a gain is a revenue gain (i.e. taxable) or a capital (non-taxable), a CGT would remove these issues.

I can see from a first consideration that a comprehensive CGT will broaden our tax base and make tax fairer. The arguments for a CGT can be summarised as to;

1 increase fairness in the income tax regime;
2 to remove investment distortions; and
3 to improve the integrity of the Income Tax Act.

I comment on the above issues.

1 Fairness and associated issues

I appreciate the issue where taxpayers invest in a capital asset and earn an "untaxed" gains where other taxpayers only earn taxable income (horizontal equity). This is not the full story.

If this were the criteria for imposing a CGT, then it would necessitate all capital gains being subject to tax including:

- Gifts and inheritances (a taxpayer gifts a house or receive a house from an inheritance)
- Lottery and gambling winnings
- Compensation payments
- Non-cash benefits such as family related interest free loans
- Acquisition of assets below market value (a taxpayer sells a house to a family member below its market rate)
- Provision of services for no charge (e.g. a taxpayer paints his/her house rather than employ a painter)

To address this fairness all forms of capital appreciation should be included. This is not practical and would create its own fairness issues, for example subjecting a gift of post-tax earnings to a family member will be viewed as unfair by many.

It is not clear what the boundary line would be of "acceptable windfall gains" and "unacceptable windfall gains". I prefer that where capital gains are in effect revenue gains, these should be brought within the tax regime. This has occurred previously, for example receipts for restraint of trade have been historically classified as being a capital receipt. It was seen taxpayers were structuring income receipts as restraint of trade, hence these receipts were deemed to be income.

The above also does not take into account the risk undertaken by the taxpayer is seeking a capital gain. A taxpayer that makes a capital investment subsequently realises that asset and receives a capital gain. If it is seen fair to tax such gains, then the taxpayer should be allowed a deduction if they make a loss. That is, to be fair, all capital losses should be tax deductible. It is highly likely that capital losses will be ring fenced.

Is it fair that a taxpayer who incurs a capital loss obtains no immediate tax deduction for this loss? Consider a taxpayer who earns wages income and builds a tax paid capital base. They invest that capital and lose their funds. They have a quarantined capital loss. They then earn wages income to recover his/her capital. The capital loss provides no benefit. Is that fair?

I do not believe fairness is the only aspect of a CGT regime, however many aspects of a comprehensive CGT will still be seen as unfair.

2 Removing investment distortions

It is often argued that the lack of a CGT results in taxpayers distorting their investment decisions. The most commonly cited example is that of residential rental homes.

As an initial comment I note that if a comprehensive CGT is implemented that exempted the owner occupied residential home of the taxpayer, then this will create an overwhelming distortion. That is, taxpayers will over invest in their residential home as that investment provides a benefit being the tax-free enjoyment of the asset and an asset that is free from any CGT. It is likely that a CGT that has the objective of removing investment distortions will likely be an own goal as everyone over invests in their own residential home.

In relation to investment distortions I believe there are limited investment decisions which are distorted by the lack of a CGT. The most obvious example was international portfolio shares. The case for reform was reasonably clear. Most international companies retain a significant portion of their profits and therefore, assuming all else remains constant, international shares will increase in value resulting in tax free capital gains. The solution proposed for the was the fair dividend rate (FDR) regime. I believe this is a highly successful regime. I also believe the FDR regime is a superior solution compared to a realisation-based CGT regime. There are many examples of international shares that do not make annual dividend payments. A realisation-based CGT regime would reduce taxation for investors in such share. Simply for completeness, I do not believe it is feasible for an unrealised CGT regime to be applied to international shares as there are many examples where such shares do not have readily available market values.

Except for residential rental properties, I do not believe there are consistent examples where untaxed capital gains are taken into account in investment decisions. I have many clients that invest in commercial property for long term rental yields. These decisions are based on existing rental returns, current interest rates, options to improve rental returns and the physical features regarding the property. I do not see how capital gains are built or can be built into the equation whether to buy such properties and therefore distort buying opportunities.

I contrast that with residential rental income. Like international shares and unlike commercial property, I cannot see how investing in such properties is undertaken with an expectation of a known or certain capital gain. That is, unlike commercial property investment decisions, in many residential properties, the rental income does not cover the cost of funding such acquisitions. There is something else that is taken into the equation which is the expectation of capital appreciation. This is currently driven by factors of limited supply and net population growth (demand) which is obvious in certain cities. I am not sure whether this will continue over the long-term future, hence I am not sure whether the expectation of capital gains will always occur. In any event, before TWG considers a CGT regime for residential property, consideration should be given whether an FDR type regime should be applied to such investments as compared with a CGT. As mentioned above, I believe that FDR for international shares works extremely well and collects more revenue for the Government in a more consistent and fair basis.

In relation to NZ equity investments, I simply see no distortion created by not having a CGT regime. Purchase decisions are based on cashflow. Where taxpayers are making the decision based on sale proceeds, I suggest they are already held on revenue account. I simply see no distortion for such investments.

Finally, in this regard, New Zealand needs more capital investment in businesses. Subjecting such investment into these business to CGT will not increase the amount of investment undertaken.

3 Improving the integrity of the Income Tax Act

As noted above, I have seen many comments from officials over the years how taxpayers are converting income gains into capital gains and hence the lack of a CGT creates integrity issues with the Income Tax Act. If this was true, then this is a compelling argument. More to the point, if it were true then officials would be arguing for changes to include such gains with the income tax act. This has occurred in a number of situations such as the financial arrangement rules and the restraint of trade issues discussed above. Quite simply if there were these major opportunities why is any income tax collected from businesses? What are these opportunities so that I can apply them?

The other consistent concern raised by officials is the difficulty in enforcing the capital revenue boundary, especially with land sales and the intention test. To a large degree, this has been addressed by the bright-line rules that apply to residential property. As noted above, I see the current issues impacting on residential rental home investment decisions. These have been and are proposed to be subject to further reform (changes to the bright line test and ring fencing of losses). The changes made to such investments are as follows:

1. removal of tax depreciation on buildings
2. limiting what assets can be classified as fitout
3. applying the bright-line test of 2 years
4. extending the bright-line test to 5 years (proposed)
5. ring fencing losses (proposed).

It certainly seems rational that some of the above changes will address the integrity issues of the tax act with respect to residential property investments. If this is not seen as sufficient, then further reform could be considered such as an FDR type regime or a targeted CGT for residential rental accommodation.

Conclusion on whether we need a CGT regime

I do not believe a strong case has been made why a CGT is required. The one area where I see potential issues regarding fairness, distortions and integrity issues is in relation to residential rental investment. This only occurs given the current commercial issues of supply and demand. If these are expected to continue, I see it is reasonable to conclude that further reform should be undertaken with respect to that asset class. I question whether this is better considered post the implementation of the various reforms that have been completed or announced.

Implementation issues with a CGT

Implementation of CGT raises <u>real and complex issues</u> that will materially increase compliance costs. The implementation issues can be of such concern that it undermines or negates the benefits of the proposed CGT reform. I contrast this to the previously repealed gift duty regime which collected very little revenue. It did however raise considerable compliance costs, there was considerable non-compliance, and there was considerable distortion in that gifts were made of $27,000 each year or on the taxpayer’s death. Such a regime was rightly repealed. Implementation decisions for a CGT can end up with the same result as what occurred for gift duty, namely a complex regime that raised many compliance costs and raised little revenue.

If a targeted response is made in relation to residential rental property (whether a CGT or FDR type regime) then the implementation issues are substantially reduced. Further, I understand that when you consider all investments made by New Zealanders, the clear majority is invested in owner occupied houses (exempt from CGT), bank deposits (fully taxed), kiwisaver (fully taxed), and residential rental homes (discussed above). I believe the real complexity of CGT arises with the other asset classes such as shares and business goodwill, which is not substantial when considering the abovementioned assets. Given this, I strongly recommend that if a CGT is advanced, it is a targeted measure in relation to residential rental homes (whether by a targeted CGT of FDR type regime).

In the appendix I comment on the implementation issues that have been identified in the TWG initial paper. I comment below on what I see are the main issues should a comprehensive CGT be advanced. Again, I do not see that a targeted response raises these issues. Our detail additional comments are outline below.

1 Imposing a CGT on international assets

a. I discuss this further in the appendix. I believe all international assets should be excluded from CGT given the measurement issues, complexity with interfacing with foreign CGT regimes, and the limited amount so invested by New Zealand residents.

b. In many cases such foreign assets will be subject to CGT in the foreign jurisdiction, hence imposing a CGT in NZ creates exposure to double tax. Officials will likely say that taxpayers can claim a credit for the tax paid in the foreign jurisdiction. The reality is that due to different calculation basis, different realisation rules, and different exchange rates, in many situations the tax credit will not be allowed.

c. Capital gains will always need to be calculated in NZ currency. Therefore, the capital gain/loss made in the foreign jurisdiction will always be completely different from the gain/loss made in NZ currency. It is not clear why a taxpayer should be subject to NZ CGT when their currency is better measured in that foreign jurisdiction, for example a foreign employee who works in NZ but unfortunately realises a foreign asset why a New Zealand taxpayer. If their stay in New Zealand is not permanent, any gain that takes into account the changes with NZ currency is a fictious gain for that taxpayer.

d. If foreign assets are included, officials are also likely to require all foreign assets own via foreign corporates and foreign trusts are also brought into the NZ CGT net if the ultimate shareholder(settlor) is NZ resident. This then raises a number of very complex issues such as ownership interest, costs basis, relevant FX rates on acquisition/commencement date, sale date, and then compounded for all additional purchases and partial disposals, periods when the asset was a primary home etc.

e. For capital gains made in disposing foreign investments or subsidiaries, such gains can be reduced by the payment of exempt dividends. This then raises subjective and complex issues whether the dividend should be accounted for in the sale proceeds etc. Many countries including Australia, United Kingdom, and South Africa have CGT exemptions when gains are made foreign subsidiaries due to these complex issues. I strongly recommend NZ follows what these other countries have done.

f. Overall, the quantum of foreign assets would be relatively small however the complexity and compliance costs will be substantial. This then rises whether this is worth doing with respect to those asserts - I recommend all foreign assets be excluded.

2 Transition into a CGT regime

a. Transition into the rules is a key design features that requires careful consideration. Australia introduced its CGT regime and applied it only to assets acquired post commencement date. On balance I prefer this option should TWG recommend a comprehensive CGT. This however creates a number of complex issues such as assets which have additions post commencement date. Clearly a $100 company owned pre-commencement date that buys a $1m assets post commencement date should be caught by CGT. Likewise, a $1m company owned pre-commencement date that buys a $100 asset should remain excluded from the CGT rules. Where the boundary line should be drawn will be complex and extremely difficult to manage. On balance I think this is better than a valuation basis on the date of introduction.

b. The alternative is that all assets are valued on commencement date (including providing the taxpayer the option to use cost as the valuation – see below). Obviously, valuers will be making considerable income given the vast amount of assets that could be subject to CGT and the many taxpayers that will seek valuations to arrive at the highest valuation. The valuation option is likely to result in many (most/all) assets being over-valued. It will not be possible for the Inland Revenue to manage disputes or even reviewing such valuations given the share volume of valuations that are likely to be undertaken. Worst, the correctness of the valuation may only be reviewed after a number of years from the commencement date when it is hard to seek records or justify such valuations.

c. If the valuation option is adopted, its seems practical that taxpayers be given the option to use the highest of valuation or cost. If this option is not allowed, there will be taxpayers who will pay CGT even though they have made no gain. Consider a taxpayer who invests in a company for $1m which is all debt funded. The company has hard times and at commencement date of CGT the company is only worth $100,000. Good times return, and the taxpayer sells the company for $1.1m and can repay their $1m debt. If the taxpayer cannot use the cost option and must use the valuation option, then they have made $1,000,000 capital gain but with a $330,000 tax liability. Allowing only the valuation option will made some taxpayer insolvent and bankrupt. It also raises the interesting issue whether loans should also be valued for CGT purposes and how this is interfaced with the financial arrangement rules. This seems complex.

d. I am also aware that there is a hybrid transitional basis where assets sold post commencement date are subject to CGT, but the taxable gain is calculated based on the time period of ownership and split between pre and post commencement of CGT on a straight-line basis. Such an approach is obviously random and certainly penalises taxpayers that hold for a long-time post commencement of CGT. This type of regime forces taxpayers to sell assets where they have made large unrealised gains before the commencement of CGT and therefore is very distortionary.

3 Double taxation and double deductions

a. One of the more significant concerns is likelihood that double taxation will arise with respect to any CGT. This arises where a taxpayer invests in a company, the company makes a gain subject to CGT. Consider a farming company owned by a number of generations in the wider family. Assume the farm is ultimately sold, the gain will be subject to CGT. If the shares are sold, gains on those shares will be subject to CGT. Depending on the design of the regime, as shares move down generations on the death of a shareholder, this may also result in tax. A number of permutation arise that all result in more than one layer of tax (being tax at the shareholder level when share transfers occur and tax at the corporate level when the farm is sold). These issues need to be addressed otherwise there will be substantial distortions and all SMEs that are structured through corporates will need to restructure as trusts.

b. Equally with double tax, I suspect officials will be overly concerned where taxpayers can claim double deductions therefore reducing their overall CGT liabilities. This occurred in Australia where most corporates are forced to use the Australian tax consolidation regime. This results in extremely complex and subjective tax laws. This will immediately and materially increase tax compliance costs.

c. In saying the above, clear rules will also need to be put forward so that where companies make capital gains that are not subject to CGT (i.e. gains made before introduction of any CGT), the effect of CGT is not caught when the company distributes those gains to shareholders. If tax arises on such gains, then the CGT regime will be seen as retrospective and taxing gains made before its introduction. This also adds to the complexity of the rules.

4 Compliance costs with private assets such as holiday homes

a. If private assets such as holiday homes and expensive boats and planes are brought into the CGT base I note this raises a new set of complex issues.

b. First, many owners of such assets may not file tax returns and have no appreciation of the tax issues they must address. Many such assets currently have no tax implications and therefore detail records are not keep.

c. The compliance costs of record keeping are significant. They have to address the issues on transition. They then have to keep detailed records of any additions. For example, with a holiday home needs to consider whether the following are capital costs - new roofs, a new garage, new driveways, repainting, acquiring native trees, etc etc.

d. Further complexities arise when family members change ownership interests whether by direct transfer of due to the death of an owner.

e. Overlaying the above, should there be an adjustment for private consumption. Consider an expensive asset which is acquired for $1m and subsequently sold for $950,000. Assume that loss is all attributable to the private consumption by the taxpayer. Is this loss a qualifying deductible loss? What if there was a gain, but the gain would have been larger if there had been no private consumption?

5 Overall compliance costs of a CGT

a. As outlined above, I see many complexities of a comprehensive CGT. I also believe there will be many behavioural changes that result. As an adviser firm I see considerable area of advice that clients will seek advice on. The key question is, are all these complexities and compliance costs are a good thing for New Zealand. Will further productive investment occur or more importantly will more productive investment (whatever this is) occur relative to other forms of investment? Will the tax system be fairer post all this complexity? Will taxpayer compliance improve. In this regard I note that officials have noted that less than 50% of taxpayers complied with the 2 year bright-line test that should have returned income from that regime.[1] I suspect the introduction of a comprehensive CGT compliance will go down however compliance costs will increase.

[1] See RSS to the proposals to extend the brightline test to 5 year, Feb 2018.

Implications for Government revenue

As a final point I note the fiscal implications of a CGT. The first point is that the revenue raised from a comprehensive CGT does not eventuate for a number of years given the transitional events. What this means is there is no ability to reduce taxes for that time from the expected increase in CGT revenue.

More importantly, should the world economy go through a market correct and economic slowdown that seems to occur every 10 years, reliance on a CGT tax base means reduced revenue for the government. That is, when the world economy went through the global financial crisis (the GFC) governments that relied on a material CGT tax base experienced a considerable reduction of revenue. This is not surprising as many asset classes reduce in value during such events. Corporates were also forced to divest assets and clearly if that result in CGT payable, they were also forced to sell loss making investments to crystallise losses. This is akin to being addicted to heroin, goods times are great, bad times are extreme poor. For this reason alone, I have real concerns making New Zealand rely on a tax base that will disappear in times when the government needs revenue the most (i.e. when benefits materially increase etc).

3 Revenue raising options

An important question is if the Government requires more revenue, where should this come from? Separate to this, should the balance of our tax collected be altered from the current mix of GST and income tax so that it is more fairer.

I refer to the 2010 tax working group (where the writer was a member of that group). Their conclusion was that if tax revenue should be raised, the best way to undertake that is to raise GST. I also note that should the GST rate be raised, benefits and low-income earners have benefit/taxes adjusted to ensure they are no worst off. This seems the fairest way to raise taxes.

If the Government considers other revenue raising options, I recommend the following:

1. GST should be imposed on all goods (no threshold) brought into NZ across the border. This can be done through electronic means and is efficient and effective.
2. The corporate and top individual tax rates should be aligned. The key question is at what rate should they be aligned to. In this regard I note:
    a. The corporate rate is generally a withholding tax on NZ resident and a final tax of foreign investment.
    b. As noted above, for direct foreign investors, the corporate rate is not the most significant settings, rather the thin capital and interest rates are more relevant.
    c. High net wealth taxpayers, the relevant tax rate is the corporate rate as all marginal income is paid at that rate (whether through corporates or PIEs).
    d. Many high-income earners cannot access the corporate rate given the nature of their income – is this fair?
    e. The optimal alignment rate is the rate where corporates and high-income earners pay the same amount of tax collectively. I do not have resources to calculate that rate.

3 No comprehensive CGT is implemented. Please refer to our comments regarding a CGT. If the Government requires more revenue, there are better ways to collect that revenue which are fairer, even just raise income tax rates.

4 Policy setting process

GTPP is not working as originally intended. There are many examples where concerns over policy decisions seem to be ignored. Examples include the above mentioned systematic changes to the international tax settings for investment into New Zealand.

Other examples have been the implementation of the AIM determinations. Concerns have been raised that the AIM determinations are unworkable and not practical, yet the submissions have not fully been taken into account.

Clearly there will never be total agreement on all issues of tax policy design. That is not the concern. The concern is there are many examples where the private sector simply does not understand why changes are been made (or not made) and concerns have not been addressed by officials.

We consider that this area need further consideration.

5 Other issues for the TWG to consider

There are a raft of issues that are micro in nature that the TWG should get officials to consider and report back given they lower compliance costs, involve small margin revenue or the remove bias regarding investment decisions. The list that I think should be considered further are as follows:

1 Exempt immigrants from rental income earnt overseas, or at least the FX on loans funding those rental houses.

a. The current setting for migrants need to be revisited, especially those that move to NZ but retained their family home in the foreign country and derive rental income from it. This commonly impacts expatriate employees who come and work in New Zealand for a short time period. If they work in New Zealand for less than 4 years, foreign income is not subject to NZ tax. If they stay longer than 4 years, or don't qualify for the four-year transitional rule, then they have a raft of complex issues regarding any rental home in their home jurisdiction.
b. The issues include returning the foreign income for NZ tax purposes which generally means undertaking a rental calculation applying NZ tax legislation and converting this into NZ currency.
c. If they have net income from this, it is likely to be subject to tax in the foreign jurisdiction and therefore any tax payable may be allowed as a credit in NZ.
d. The above is not simple but it is manageable and more importantly it is understandable which lowers compliance costs and improves taxpayers meeting their obligations. I might add, I am not sure there is any major revenue in this, namely either allowing losses or taxing profits with a corresponding foreign tax credit for taxes paid in the foreign jurisdiction.
e. The more complex issue is the NZ tax implications of any foreign currency mortgage on these rental properties. What is more difficult is that the loan balances are converted in NZ currency each year therefore producing FX gains or losses. That is, if the NZ currency weakens against the taxpayer's home currency there are large tax deductions and if the NZ currency strengthens, there will generally be significant amounts of income. What is

most difficult is that from the taxpayer's perspective they have a foreign currency hedge (being the loan and asset both being in foreign currencies) and there is no economic gain or loss. As such they have difficulties understanding why this is subject to tax noting that it is outside their control.

f. There are some complex rules regarding the ability to use a cash basis and defer FX gains and losses, however this has its own problems. I suggest that the income and expenses and the FX treatment on the loans are all totally ignored from a NZ tax perspective. Failing this, FX on loans should be permanently ignored.

g. Just for completeness, if a CGT is imposed on such assets I see substantial compliance costs and significant non-compliance. Taxpayers who are well advised will try and place such assets in structures (i.e. foreign trusts with no NZ trustee) before they come to NZ and therefore avoid all these taxes. It seems very bad policy design that those taxpayers who seek good professional advice will correctly avoid these taxes whereas other will have high levels of compliance costs and unknown tax liabilities (which will predominately be based on FX movements which are outside their control)

2 Allow refunds of imputation credits except for charities and non-residents.

a. The current tax settings do not allow excess imputation credits to be refunded. For most taxpayers, the excess imputation credit is used against other income and therefore they receive refunds of the taxes due on the other income. For example, if a superannuant has super and some fully imputed dividend income, the imputation credit is a credit of 28% and exceeds their margin tax liability, likely to be 17.5%. When they file a tax return, they get a refund of the excess of 10.5% being a refund of the PAYE deducted on their super.

b. If the taxpayer has no other income, then they cannot receive a refund of the excess imputation credit, but they can obtain a refund of the 5% RWT deducted on the dividend. The excess imputation credit should also be refunded. The Government may wish to prevent imputation credits being refund when paid to charities and obviously non-residents, however the current limitations simply adds complexity and compliance costs. I suspect that the numbers are not that large. Finally in this regard, excess imputation credit still represent excess tax paid by the shareholder and should, on pure policy grounds, be refunded.

3 Allow depreciation on commercial buildings, they do depreciate however the tax act provides no relief for this. The best example of this has been the number of buildings that have been demolished around Wellington. Outside the buildings that were deemed to be inhabitable due to the earthquake, there has been a number by buildings that have been demolished given they simply are not up to acceptable levels of the new building standards. They have clearly reduced in value, some of which is simply due to the changes of the building code, i.e. a regulatory cause for their reduction in value. This would have to be one of the clearest examples of unfairness in the tax settings. This should be resolved by allow commercial and industrial building to be depreciated for tax purposes.

6 Other issues that the TWG should not consider, rather the TWG should confirm existing settings

As noted above the NZ tax regime is very respected international and has a number of regimes that operate very well. These reduce compliance cost and improve certainty.

Changing these regimes will fundamentally increase the stress and tension between the Inland Revenue and the SME sector.

The regimes that should be endorsed by the TWG include (I include those regimes and brief comments which I can expand on if required):

1 Imputation credit regime (IC regime)

a. The IC regime is a hall mark of the NZ tax system. It basically means that SMEs can operate either as sole traders, partnerships, trading trusts or corporate structures without tax being a major factor. If the IC regime was removed it would result in many SMEs that have structured as a corporate to reconsider their structure.
b. The IC regime prevents the historic double regime that previously operated and that operates in a number of different countries. If it were removed, then it is likely all shareholders will want to extract profit by way of directors/shareholders/consulting fees, or interest to prevent double taxation. To combat taxpayers doing this, it will then result in a large number of anti-avoidance regimes to dictate what are essentially commercial decisions what will have to effect of placing more debt on corporate structures (even listed corporates). This is a perverse outcome.
c. As noted above, I recommend that where taxpayers have excess imputation credits on dividend income, these excess credits should be refunded.

2 Statutory deduction for interest for corporates

a. The statutory deduction for interest expenditure allowed to corporates materially reduces compliance costs for all large corporates and all SMEs.
b. Before the statutory deduction was provided for, many large and SME corporates regularly and routinely sought advice and structured their affairs to enable interest deductions. I recall that one major corporate established a new subsidiary every time it paid a dividend as there was a statutory deduction for interest costs when borrowing funds to subscribe for equity in a company. Obviously, the borrowings were then used to fund the payment of a dividend. This was all just heavy compliance costs. Material compliance costs savings have occurred by having a statutory deduction for interest costs.
c. The boundary line that is established is that all interest is tax deductible as long as there are comprehensive dividend rules that apply to cash and non-cash dividends. In our experience this is operating very well.
d. Obviously, some interest costs are not fully deductible, namely interest subject to the thin capitalisation regime, the mixed-use asset regime and more recently in relation to cars which provide a fringe benefit to shareholder employees. The mixed-use asset rules are a good example how not to do tax policy. Those rules are extremely complex if there is a mixed-use asset present and I suspect has very low levels of compliance by taxpayers. For example, where a corporate group owns a mixed-use asset, the rules effectively deem that the mixed-use asset is 100% debt funded and any debt in the corporate group or any major shareholder is first used to fund the mixed-use asset.

3 Overdrawn current accounts

a. I have heard several policy officials raise whether all overdrawn current accounts should be treated as a deem dividend. This will be a bad policy decision that lacks a detailed understanding how the rules in this respect operate.

b. Most SMEs do not pay wages and salaries to shareholders that is subject to PAYE. This is because most do not earn regular cash flow to pay shareholders that can be subject to PAYE. In months due to clients not paying or irregular income patterns, there is simply not sufficient cash to pay shareholders that month. What happens in most such SMEs is that during the year shareholders take cash when cash is available. These are accounted for as overdrawn current accounts. At the end of the year, when the annual profit is known, a journal entry is undertaken which debits wages expense and credit the shareholder's current account. The Tax Act deems this credit to the current account to occur at the first day of that income year, which in most cases places the current account into credit. They only have a debit balance at year end if they the annual cash drawings exceeding that year's salary (ignoring opening balance). If they have a debit balance, interest is calculated from the date when the current account went into debit (i.e. overdrawn). This works perfectly well. The shareholder is most likely to have being paying provisional tax on the salary during the income year. To alter this will result in SMEs needing to determine their annual taxable profit before taking any cash is taken – this is simply not workable.

c. Where a shareholder has an over drawn current account, the tax liabilities of this are addressed by requiring the interest to be charged to the shareholder at the FBT rate (currently 5.77%) (if interest is not charge it gives rise to an actual FBT or dividend RWT cost). This interest charged to shareholders on the overdrawn current account is taxable income to the company and is generally (i.e. almost always) non-deductible to the shareholder. This is no different from the shareholder borrowing from a bank to meet his/her living costs. There is no tax advantage of overdrawn current accounts. If officials believe there is a tax advantage I would be happy to meet with them to discuss.

d. I can see an issue if the shareholder <u>can never</u> repay the overdrawn current account. In our experience the Inland Revenue has been successful arguing for tax on a technical debt remission. I would be happy to discuss this further if required.

I am happy to provide further information on the above options.

I am happy to discuss our conclusion above.

Yours faithfully
Olivershaw Limited
[1]

Mike Shaw
Director
[1]

Capital Gains Tax (CGT) Design Issues

	Key Design Considerations	Comment
1	Should CGT be a separate tax or part of income tax?	Best taxed as part of income tax. If the decision is made to tax such gains, then additional complexity will arise if a new regime is developed. If another regime is developed, questions needs to be consider whether existing capital gains that are taxed should also be taxed under this new regime. It is simplest just to deem the gain to be taxed as income.
2	Should capital gains be taxed on realisation or accrual basis?	Ideally gains should be taxed as they accrue. This approach is simply not feasible or practical given the valuation difficulties and cash flow implications. This then creates several distortions such as lock in distortions and issues when taxpayers die or leave New Zealand.
3	What assets should be covered?	If a CGT is to be introduced it should be comprehensive, covering not only physical assets but intangible property, rights and extinguishment of rights. This is not practical or feasible. The family home has already been excluded. Further decisions will need to be considered such as: • Lottery gains (and treatment of losses) • Gambling gains (and treatment of losses) • Cash inheritances • Treatment on death • Treatment on death of non-residents (but NZ resident beneficiary) The family home is the most material asset owned by NZ residents, but it is excluded. This will create a major distortion as taxpayers will seek to avoid CGT simply by over-investing into their residential house. For this reason, this is a material flaw in any proposal to introduce a CGT. For completeness we note the compliance costs of including the family home is substantial.

	Key Design Considerations	Comment
		Consideration should be given to where "issues" arise and include such gains within the income tax net. The areas of concern seem to be the residential rental home as capital gains appear to be expected gains which are taken into account before making such investments. If this is correct, this is perhaps a reason for taxing such gains. We are unaware of any other areas of concern, namely where the tax settings create distortions.
		Our preferred option is simply to target areas where the existing tax settings are causing distortions and a CGT or FDR type should be introduced to address those issues (targeted response). We also provide comments should a comprehensive approach be considered
3a	Should assets held by KiwiSaver and other savings schemes be subject to tax?	*Targeted response* – no comments required as these assets would not be subject to a CGT *Comprehensive approach* All assets should be taxed unless a targeted approach, such as taxing residential rental homes. Many Kiwsaver funds invest in international shares. If anything these seem to be currently overtaxed under a 5% FDR. We can see no benefit in changing the setting other than to adjust the 5% FDR rate. It seems interest income is over-taxed in such long-term investment vehicles. Consideration should be given to reducing the tax rate on such interest income in these funds.
3b	Should assets held offshore be subject to tax?	*Comprehensive and targeted response* There are a number of issues that we believe means that such assets should be EXCULDED. First what is the gain we are trying to tax. In many situations the gain should be measured relative to the foreign currency, taxing some fictitious gain relative to NZ currency is meaningless. Take for example an employee of a MNC who works in NZ for only say 5 years. Any capital gains relative to the NZ dollar are fictitious as they are really concerned with gain relative to their home jurisdiction. Second, many foreign capital gains <u>are</u> subject to tax in the foreign jurisdiction or <u>will be</u> subject to tax in the foreign jurisdiction. Why are we subjecting such gains to double tax? We appreciate that even if a with a targeted approach of taxing residential rental home, our recommendation would be that these foreign residential rental homes would be excluded from the base. When you consider the FX and foreign currency value change on both the asset and the debt, potential foreign tax credits on the foreign value change, residential home exemption (and apportionment between rental use and owner occupier use) this all becomes too complex and the compliance costs will not warrant any tax that may be collected.

	Key Design Considerations	Comment
3c	How should gifts and gambling winnings be taxed?	*Targeted response* – no comments required as these gains would not be subject to a CGT *Comprehensive approach* Gifts and gambling should be excluded as these are windfall gains made without any material behaviour change/investment distortion. There is limited policy justification for include such gains in the CGT base. Gambling is more akin to a consumption item and should be taxed as such (i.e. subject to GST etc as it presently that case) Gifts and gambling should also be excluded otherwise deductions should be provided where taxpayers lose on such transactions. It would be considerable over taxation if all receipts were taxable with no relief provided for the losses. Gifts should also be excluded from CGT based on our practical grounds. If gifts were included, then it should be all gifts. However, many gifts are provided at no monetary consideration and hence impossible to measure. It is also not clear how deductions would operate if gifts were allowed as a deduction. We have previously had a gift duty applied to many gifts over $27,000. It was concluded that the compliance costs associated with this was considerably more than the tax revenue it collected. .
3d	Should there be a de Minimis rule?	*Comprehensive and targeted response* There should be a de Minimis rule to reduce compliance costs if a comprehensive CGT is pursued. The de minimis should be considerable given the compliance costs that result from such a tax. We would suggest that the assets have to exceed $500,000. If a targeted CGT is pursued as per our recommended, then no de minimis should apply. .
4	CGT events/realisation	*Targeted response* If a targeted CGT is pursued as per our recommended, then realisation should be the events that triggers a CGT liability. *Comprehensive* If a comprehensive CGT regime is pursued, then complex rules need to be taken into accounts such as:

	Key Design Considerations	Comment
		• realisation (sale/assignment/gift/transfer etc) • Death/distribution • Migration • Sale by certain leases • Assignment • Resettlements • Deem sale if sale of shares needs to be considered.
4a	How should matrimonial property settlements be treated?	*Comprehensive and targeted response* Treatment should be consistent with existing rules with existing relationship property transfers. Specifically, a such transfers should be excluded for CGT purposes.
4b	How should disposal of assets on death be treated?	*Targeted response* If targeted extensions are made such as residential rental property, then the existing rules that apply to revenue account property should apply. *Comprehensive response* Ideally, if a comprehensive CGT is pursued, CGT should crystallise on a taxpayer's death. This raises obvious issues resulting in taxpayers having to sell assets to fund the tax liability. This was a major issue with NZ previous estate duties tax, namely when a farmer died, the family was forced to sell the farm to fund the 40% rate of estate duty. Given these issues, there should be a roll over on death and the cost basis of the deceased should carry forward to the estate and then beneficiaries should the beneficiaries retain the asset. There should be no step up of costs at this time, if there is such a step up for political reasons, then this would undermine the entire regime, namely taxpayers are forced to hold assets until they die. Another issue that arises is where a taxpayer own shares (especially wholly owned companies) in a company that has assets subject to CGT. Consider where a farmer operates through a wholly owned company where s/he owns all the shares. The taxpayers dies. If this triggers CGT, the entire value of the farm will be crystallised in the value of the shares. Immediately post the famers death, the company sells the farm. This also triggers CGT with no offset

	Key Design Considerations	Comment
		allowed in relation to the tax paid by the farmer. This effectively doubles the rate of CGT and seems totally unwarranted.
4c	How should emigration be handled?	*Targeted response* If a target expansion occurs, no CGT event needs to occur as the land remains in New Zealand. Given this, the CGT event should be deferred until realisation occurs. *Comprehensive response* If a comprehensive CGT is pursued, when a taxpayer leaves NZ, assuming it is a permanent departure, then CGT triggered at that time. This is important otherwise the integrity of the CGT regime will be undermined by taxpayers avoiding CGT on non-NZ property by simply leaving NZ. In Australia, when a taxpayer ceases Australian residency, for non-land assets, we understand the taxpayer has the choice to pay CGT based on the valuation at that date, or the taxpayer can defer until the date when the taxpayer sells the asset. We understand that raises collection issues. This entire area is extremely complex and raises considerable uncertainty, compliance costs (advice and valuations) and non-compliance (especially given the inability to track ultimate sale of such assets and collect tax from non-residents with no connection with Australia). If the emigration is not permanent, then there should be no crystalisation of any CGT.
4d	How should immigration be handled?	*Comprehensive and targeted response* Like migration, this is extremely complex area. The first response is to require a valuation of assets when taxpayers first becomes resident post the transitional residency period (noting not all new taxpayers may qualify for the transitional residency period). Such taxpayers will likely have foreign assets in foreign currencies. As an initial comment, it makes little sense giving rise to a CGT liability based on NZ currency and for assets acquired without any consideration of moving to NZ. High wealth taxpayers have complex structures and many assets which do not have readily available market values which makes initial valuation difficult. Complex issues then arise how to calculate CGT liabilities when realisation is made by structures (trusts and corporates) established by such taxpayers. This is overly complex. Australia deems gains made by the foreign structure to be subject to Australian tax based on the entire gain if the structure is passive in nature. This is the entire gain, not that gain made by the person was resident in Australia. Further the taxpayer can have an Australian tax liability even in situations where the economic gain is not received by the taxpayer.

	Key Design Considerations	Comment
		There are issues when the foreign jurisdiction taxes such foreign asset under a CGT regime and therefore raising double tax. This all leads us to conclude that it is best to exclude all such foreign assets, especially in the scheme of all events, this is a minor asset base and certainly not an asset based that drive any adverse behaviour change (i.e. the asset was acquired before entering into NZ). .
4e	When should non-residents be subject to tax?	*Comprehensive and targeted response* Australia only imposes CGT on land assets or land rich companies. We believe that a similar rule should be imposed in NZ if a comprehensive CGT is pursued. If a target CGT regime is applied to residential rental, then they would also be subject to CGT even if the owner is a non-resident. .
4f	How should family trusts be integrated into the system?	A family should be treated as a taxpayer no different from a corporate.
5	Should capital losses be ring fenced?	*Targeted response*: • Losses should not be ring fenced and deductible against ordinary income. There is little ability to manipulate losses given it involves the sale of real property that give rise to its own compliance costs. *Comprehensive response* • To reduce compliance costs and complex boundary issues, losses should be immediately tax deductible and deductible against ordinary income. • That said, the ability to bring tax losses will likely pose a material revenue cost therefore resulting in such complex rules to ringfence such losses Ring fencing rules unwind all compliance costs savings of removing the capital revenue boundary, Rather, such a rule is likely to result in taxpayers arguing that capital account assets are now held on revenue account so that any losses become immediately deductible.

	Key Design Considerations	Comment
6	Should there be roll over relief?	*Comprehensive response* Roll-over relief will be needed otherwise a CGT will result in many unwanted incentives, for example lock in features for many assets Roll over should be allowed in the situations where the taxpayer dies. Consider a company that is wholly owned by a deceased taxpayer. It seems very bad policy design that any gains on the death of the taxpayer will be crystallised where the same gain will arise when the company disposes of the asset. Rollover would not be required if the targeted approach is pursued Corporates/SMEs require roll-over relief otherwise restructuring and M&A activity will have an unwarranted tax impediment.
7	Should any allowance be given for inflation in calculating capital gains?	*Comprehensive response*: With a comprehensive CGT regime, assets will be taxed when that are held over considerably long time periods. Over such periods inflation is a real issue. To not recognise the effects of inflation will result in unfair outcomes. For example, if an asset is acquired for $500,000 band is disposed of in 10 years' time for say $600,000 there would appear to be a gain of $100,000. If inflation occurred during that time that meant the $500,000 is now worth $650,000, economically the taxpayer has suffered a $50,000 loss. To now tax the $100,000 gain will be to increase the losses made by the taxpayer. The only logical solution is to remove the inflation portion of the gain. Some countries have address this by adjusting the rate of CGT by reduce the level of inclusion of capital gain subject to CGT. These approaches add considerable complexity and introduce additional boundaries which do not solve the issues with inflation.
8	What should the rate of tax on capital gains be?	*Comprehensive response* If the decision is made to tax capital gains, then the tax rate should be the tax rate applying to ordinary income. Having a different rate simply adds complexity and boundary issues.

	Key Design Considerations	Comment
9	How would a CGT integrate with current tax laws?	To minimise compliance costs, capital gains should simply be deemed income. Assuming this, further comments are added below. *Comprehensive response* The FDR rules will need to be reconsidered. The FDR regime should be repeals and replaced with a CGT. We note this is likely to reduce government revenue given the ability for long term investors to defer ultimate realisation and NZ tax. We believe there should be an active exemption for capital gains made by CFCs. This is what the Australian rules provide for. This is partly due to most capital gains are taxed in foreign jurisdictions and most dividends are tax exempt when paying dividends from foreign CFCs. That is, if a CFC is to be sold resulting in a large capital gain, this gain can be materially reduced (if not eliminated) by simply paying a large pre-sale exempt dividend. If rules are designed to prevent this, it will result in overly complex rules the have illogical boundaries. Hence, we recommend an exemption be provided for capital gains made by CFCs. The livestock regimes will need to be reconsidered. Currently many farmers apply the herd livestock regime which result in the farmers opening stock being revalued using that years closing stock figures. This produces a tax-free capital gain. If a comprehensive CGT is put in place the initial view would be that these revaluations be treated as taxable amounts however this is an unrealised capital gains tax that will result in farmers paying tax even though they have not realised any cash profits. Rules prevent double taxation will be required. For example, in a situation of a widely held family company which has material untaxed capital gains, say on farm land. In such circumstances there are commonly changes between the various shareholders. If such share changed occur which trigger capital gains, there is unlikely to be any relief for the full CGT payable if the farm is sold. This is a clear and unjustified imposition of double tax. Equally with double tax, officials are likely to require complex rules to ensure taxpayers do not double count deduction (or cost basis).

	Key Design Considerations	Comment
10	What administrative implications would there be from a CGT?	Administrative and compliance costs will be substantial. *Comprehensive response* With a comprehensive CGT, there will be many taxpayers that do not file tax returns and do not have advisers that may be subject to the rules. This is obviously subject to the breath of such a CGT. It will likely include holiday homes, direct shareholdings in listed companies (many of these people who own few shares do not have to file tax returns, especially if their margin tax rate is 33%). These taxpayers will need to keep records of the original cost, capital improvements, treatment of dividend reinvestments, disposals, off-market transfers, gifts etc. Depending on design there will potentially be greater number of taxpayers that have to file returns and obtain valuations. Compliance with CGT legislative requirements would be beyond the majority of average taxpayers necessitating the use of professionals and increasing compliance costs.
11	What rules should govern the transition into a CGT?	*Comprehensive and targeted response* The options would appear to be to apply the rules to: • Assets acquired post a set date (i.e. pre-CGT assets excluded; or • At the election of the taxpayer, the higher of market value of cost. We discussed this above. Both options have major shortcomings and substantial compliance costs. On balance we prefer the Australian approach to only apply CGT on assets acquired post CGT.
12	Other matters for consideration	Other issues include: • Whether a CGT provides comfort for depreciation on buildings to now be allowed (which we argue should be addressed in any event) • How depreciation on assets subject to CGT interface

	Key Design Considerations	Comment
		• How to prevent double taxation and double deductions (partly noted above) • What assets are subject to the regime, e.g. holiday homes, luxury/high priced cruise ships, barges, artwork, jewellery • How do interface CGT with private consumption – with holiday homes and partly private assets, a CGT (if applied) only taxes the gain post any reduction in value due to consumption – how is this adjusted for? For example, where a taxpayer buys a holiday home (or boat, plane etc) and sells it as a loss, that loss is entirely due to the cost of consumption by the taxpayer. Why is this a deductible capital loss? If the asset is sold at a gain, that gain also reflects 100% cost of the reduction due to consumption by the taxpayer? • What receipts are subject to CGT, compensation payments, civil damages, defamation receipts etc