



# Future of Tax

*Final Report Volume I*

*Recommendations*



*Tax Working Group*

*Te Awheawhe Tāke*

**‘Nāu te rourou, Nāku te rourou, ka ora ai te iwi’**

*‘With your contribution and mine, the people will prosper’*

Published on 21 February 2019 by the Tax Working Group, New Zealand.

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ISBN: 978-1-98-858003-6 (Online)

The URL at February 2019 for this paper is:

<https://taxworkinggroup.govt.nz/resources/future-tax-final-report-vol-i>

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# Preface

Since the release of our *Interim Report* in September 2018 the Tax Working Group has undertaken further rounds of engagement and consultation. Alongside this process, the Group has developed and further refined its conclusions outlined in the *Interim Report*.

The engagement process has reached out to various parts of society, including Māori, civil society, tax professionals, business and environmental organisations. There has also been discussion with tax professionals in Australia to learn from their experience. This engagement reflects and is reflected in the work the Group has undertaken since early September.

As might be expected, the submissions on the *Interim Report* contained a wide variety of opinions. They ranged from full endorsement of the recommendations in the *Interim Report*, often wishing to see at least some of them go further, through to substantial rejection of the majority of the recommendations.

Those wanting to go further were bunched into two clusters. The first primarily wished the Group to consider matters outside its Terms of Reference, such as the tax:welfare interface and higher tax rates (particularly for those on higher incomes). In this cluster there were also some who wished to revisit areas that the Group had already carefully considered, with a clear majority recommending no change (such as for a financial transactions tax).

The second cluster was largely composed of groups or individuals wishing to strengthen or extend some part of the recommendations. These were most often concerned with environmental issues or the *Interim Report's* conclusions on behavioural taxes (which some wished to be renamed health promotion taxes).

The Group has carefully considered these submissions but has not accepted them all. In particular, we have adhered to our Terms of Reference, though we have made some incidental comments where we deemed it appropriate.

We have also reaffirmed the views expressed in the *Interim Report* concerning the purposes of tax. This report does not repeat those sections in full. Similarly, it does not repeat a number of other sections from the *Interim Report* where we have made no changes.

In other words, the Group's consideration of particular propositions continues to reflect the fundamental proposition that there are three main ways in which the tax system supports the wellbeing of New Zealanders: as a fair and efficient source of revenue; as a means of redistribution; and as a policy instrument to influence behaviours.

There was broad but not universal support for this position from submitters. As far as the *Interim Report's* specific recommendations are concerned, those rejecting them did so primarily in relation to the chapter and the appendix dealing with the extension of capital gains taxation. Where possible, the Group has taken account of those submissions, especially in relation to the vexed question of compliance costs.

Since the *Interim Report* the Group's internal discussions have focused primarily on the extension of capital taxation. Given what capital income is taxed already, that has meant consideration of the taxation of capital gains. Despite differences of opinion on how far such taxation should go, the Group agreed that whatever is done should be part of the general income tax system and not a separate capital gains tax regime. The reasons for this are explained in this report.

As I have indicated above, the Group was not of one mind on whether the proposed regime should proceed. A clear majority (eight to three) supported that position. But I should note and thank the three in the minority (Joanne Hodge, Kirk Hope and Robin Oliver) who played a full part in the lengthy development of the technical details. Their contributions were invaluable.

It needs to be emphasised that this difference of judgement relates to the rather simplistic binary decision of being for or against the package of capital gains taxation as a whole. In reality, that is not the only question for the Government (or Parliament) to consider.

As this report emphasises, it is possible to introduce the package in whole or in part, whether all at once or in stages. The balance between revenue and equity on the one hand and complexity and compliance costs on the other differs between asset classes. The most complex asset class is arguably the active business one – as Volume II of this report demonstrates.

This report is about much more than capital gains taxation. I would draw attention, in particular, to the work done on encapsulating the Wellbeing

Framework within a Māori world view (Te Ao Māori). This then flows into the substantive section on environmental taxation that goes beyond the near-term challenges to a longer-term tax framework to underpin a circular economy.

It should be noted that no attempt has been made to incorporate possible revenue from environmental taxation in the development of revenue- or fiscally-neutral packages. Suffice to say that environmental tax revenue could be recycled in a number of ways, especially to fund and support a faster transition to a circular economy, as well as offsetting the impact of such taxes on modest-income households.

Finally, let me thank all the members of the Group for their thoughtful participation and especially their forbearance of my occasional impatience. Our officials have been dedicated and assiduous in carrying out their tasks. It is difficult to single out anybody but Bevan Lye's work as the principal scribe on the *Interim* and *Final Reports* has been masterful. Last but far from least, our independent advisor, Andrea Black, has laboured mightily to ensure a diversity of views has come before us.

Hon Michael Cullen, KNZM  
Chair, Tax Working Group

February 2019

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# Executive summary

## A national conversation on the future of tax

1. Over the past year, the Tax Working Group has engaged in a national conversation with New Zealanders about the future of the tax system. Thousands of New Zealanders – including iwi, businesses, unions and other organisations – have had their say. It is clear to the Group that tax matters to everyone.
2. There is good reason for this passion. The tax system underpins the living standards of New Zealanders in three important respects: as a source of revenue for public services, as a means of redistribution, and as a policy instrument in its own right. The Group has been alert to these multiple purposes in the course of its work.
3. The Group also considers it is important to bring a broad conception of wellbeing and living standards to its work, including a consideration of Te Ao Māori perspectives on the tax system. This approach reflects the composition of the Group, which includes members with a diverse range of skills and experience, including from beyond the tax system.
4. As part of this work, the Group has begun to develop a policy framework that would bring together concepts from Te Ao Māori, the four capitals of the Living Standards Framework, and principles of tax policy design.
5. This framework – He Ara Waiora – draws upon the concepts of waiora (wellbeing), manaakitanga (care and respect), kaitiakitanga (stewardship/guardianship), whanaungatanga (relationships and connectedness) and ōhanga (prosperity).

6. The Group's work on He Ara Waiora appears to have resonated with many people. In light of this feedback, discussions have been initiated with the Treasury about how He Ara Waiora could inform the ongoing evolution of the Living Standards Framework.

## The structure, fairness and balance of the tax system

7. One of the key tasks for the Group has been to assess the structure, fairness and balance of the tax system. Although the tax system has many strengths, the Group has found that the tax system relies on a relatively narrow range of taxes and is not particularly progressive. There are a number of reasons for these outcomes but two issues it can address within its Terms of Reference stand out for the Group:
  - **The treatment of capital gains.** Unlike most other developed countries, New Zealand does not generally tax income in the form of capital gains (except in some specified instances). The inconsistent treatment of capital gains reduces the fairness of the tax system. It is also regressive, because it benefits the wealthiest members of our society. Both effects weigh against the sense that New Zealanders are all making a fair contribution, and risk undermining the social capital that sustains public acceptance of the tax system and so our shared prosperity in the long term.

- **The treatment of natural capital.**  
New Zealand makes relatively little use of environmental taxation. There are clear opportunities to increase environmental taxation, both to broaden the revenue base and to help address the significant environmental challenges we face as a nation.

## Final conclusions

### The taxation of capital gains

8. All the members of the Group agree that there should be an extension of the taxation of capital gains from residential rental investment properties. Eight members of the Group support the introduction of a broad approach to the taxation of capital gains. This would involve a realisation-based tax that is applied to capital gains on a broad range of assets, at full rates, with no allowance for inflation.
9. In reaching this judgement the majority of the Group accepts that extending the taxation of capital gains would involve an increase in compliance and efficiency costs but judges that these costs would be outweighed by reductions in investment biases, as well as improvements to the fairness, integrity and fiscal sustainability of the tax system. Moreover, some of these costs could be offset by other measures within a package of tax reform.
10. Three members of the Group have reached a different judgement.<sup>1</sup> These members prefer the incremental approach of extending the tax base carefully over time, which they consider has served New Zealand well over many years of tax reform. In their judgement, the revenue benefits, perceptions of fairness and possible integrity benefits, would be outweighed by adverse efficiency impacts, increased compliance and administration costs and fiscal risk.

### Choices and options

11. The Government does not face a binary choice regarding whether or not to extend capital gains taxation. There is a spectrum of choices for the coverage of assets and the inclusion of each asset class will come with its own costs and benefits.
12. At one end of the spectrum, there is a clear case to include residential rental investment properties. At the other end of the spectrum, there will be greater complexity regarding the treatment of corporate groups, unlisted shares and business goodwill.
13. For this reason, the Government could choose to extend the taxation of capital gains to some asset classes only. The Government also has options about how to stage the timing of introduction, whether to phase in asset classes, whether to grandparent some or all asset classes and whether to apply the deemed return method.

### The importance of effective implementation

14. Regardless of their position on the merits of extending the taxation of capital gains, all members agree that the introduction of a system for taxing capital gains would be a significant endeavour requiring the full attention of the Government.
15. If the Government decides to proceed, it is crucial that Inland Revenue is fully resourced and has the capability to develop and implement the new tax. The policy and legislative processes must also include thorough consultation with a diverse range of voices, using both formal and informal channels.
16. The Group also notes that the Government's stated timeframes for implementing tax reform will be challenging. The Government will need to ensure additional resources are available for implementation if these timeframes are to be achieved.

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<sup>1</sup> These members are Joanne Hodge, Kirk Hope and Robin Oliver. A note summarising their view is available at <https://taxworkinggroup.govt.nz/resources/twg-bg-4050912-extending-the-taxation-of-capital-gains-minority-view>

17. If the Government decides not to extend the taxation of capital gains to all asset classes, Inland Revenue will need to enforce fully the existing capital/revenue boundary. This includes taking test cases, as well as policy and investigative attention to existing areas of concern.

## Environmental and ecological outcomes

18. The Group considers there is significant scope for the tax system to play a greater role in sustaining and enhancing New Zealand's natural capital. New Zealand faces significant environmental challenges that require profound change to existing patterns of economic activity. Taxation is one tool – alongside regulation and spending measures – that can support and guide this transition.

19. The task for policymakers is to think in terms of systems change and to develop a set of goals and principles that can guide a transition, over many decades, to a more sustainable economy.

20. In the short term, the Group recommends better use of environmental taxes to price negative environmental externalities. Environmental taxes can be a powerful tool for ensuring people and companies better understand and account for the impact of their actions on the ecosystems on which they depend. The immediate priorities should be to expand the coverage and rate of the Waste Disposal Levy, strengthen the Emissions Trading Scheme and advance the use of congestion charging.

21. In the medium term, environmental tax revenue should be used to help fund a transition to a more sustainable economy.

22. In the longer term, environmental taxes could become a much more significant part of the tax base through the development and adoption of innovative new tools to measure and value environmental impacts.

23. As an initial step, the Group has developed a framework for deciding when to apply taxes to address negative environmental externalities.

### A framework for taxing negative environmental externalities<sup>2</sup>

Taxation can be used as a tool to enhance natural capital when unpriced externalities lead to the over-exploitation of resource stocks and degrade the integrity of ecosystems.

The benefits of using taxation as an instrument may be greater when there is *high behavioural responsiveness*, a *diversity of responses* available and significant *revenue-raising potential*.

The suitability of taxation as a policy instrument (relative to other potential instruments) can be assessed through the following criteria: *measurability*, *risk tolerance* and *scale*.

The principles of tax policy design described in Chapter 2 of this report can also apply to environmental taxes. Building off these, there are seven design principles that warrant particular attention: *Māori rights and interests* must be acknowledged and addressed; *distributional impacts* must be assessed and mitigated; the suite of responses should reflect the *full cost of externalities*; the price should *vary locally* where there is local variation in impacts; *international linkages* should be considered; the tax should be *integrated with other policy*; and *intertemporal fairness* should be considered.

24. The Group has also found that New Zealand has limited institutional capability to design and implement environmental taxes. The Group recommends that the Government strengthen its environmental tax capability. This includes support for the Parliamentary Commissioner for the Environment, which should be resourced to provide independent advice on environmental tax policy.

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<sup>2</sup> See Chapter 4 *Environmental and ecological outcomes* for a more complete description of the framework.

# The taxation of business and savings

## Business and productivity

25. The current approach to the taxation of business is largely sound. The Group does not see a case to reduce the company rate at the present time or to move away from the imputation system. However, the Government should continue to monitor developments in company tax rates around the world, particularly in Australia. The tax rate for Māori authorities also remains appropriate (although the rate should be extended to the subsidiaries of Māori authorities). The Group recommends against introducing a progressive company tax.
26. The Group has investigated and recommended a number of tax measures that could enhance productivity. These include changes to the loss-continuity rules, expanding deductions for 'black-hole' expenditure and concessions for nationally significant infrastructure projects. Some or all of these measures could form part of a package of tax reform.
27. The Group also assessed the merits of restoring building depreciation deductions. Subject to fiscal constraints, the Government could consider restoring depreciation deductions if capital gains taxation is extended.
28. The main focus of many submissions, however, was on the treatment of multinationals and digital firms. In this regard, the Group notes that New Zealand is currently participating in discussions at the Organisation for Economic Co-operation and Development (OECD) on the future of the international tax framework. The Group supports this process but recommends that the Government stand ready to implement an equalisation tax on digital services if a critical mass of other countries move in that direction.

## Retirement savings

29. New Zealand currently offers few tax incentives for retirement savings. The Group does not see a case to reform radically the taxation of retirement savings. However, the Group does support an increase in the tax benefits for low- and middle-income earners provided through KiwiSaver to encourage people to put more away for their retirement. There is also a case to exempt the New Zealand Superannuation Fund from New Zealand tax obligations.
30. The Group notes that, as lifespans have increased, people are now spending a much greater proportion of their lives in retirement. Although the Group has decided it is not necessary to adjust the tax system for inflation, we have identified a need for further work on options to maintain the purchasing power of people's savings through their retirement.

## Personal income taxation

31. Any changes to personal income taxation will need to reflect the objectives of the Government.
  - If the Government wishes to improve incomes for very low-income households, the best means of doing so will be through welfare transfers.
  - If the Government wishes to improve incomes for certain groups of low- to middle-income earners, such as full-time workers on the minimum wage, then changes to personal income taxation may be a better option.
32. The Group has discussed a range of options to increase the progressivity of the personal tax system. The Group's preferred approach is to increase the bottom tax threshold. This could potentially be combined with an increase in the second marginal tax rate.<sup>3</sup>

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3 The Group's Terms of Reference rule out increases to any rate of personal income tax. However, it would be possible to increase the second marginal tax rate (paired with increases in the bottom tax threshold) such that average tax rates do not increase for higher income earners.

33. Alongside these tax changes, the Government should consider increasing net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same income. This would provide a fairer redistribution of revenue across individuals and have a greater impact on poverty reduction.
34. Overall, the personal tax changes discussed in this report are likely to have a minor impact on income inequality. A material reduction in income inequality through the personal tax system would require broader income tax changes, including an increase in the top marginal rate. Such a change is beyond the scope of the Group's Terms of Reference.
37. While each package focuses on different themes, they all involve substantial reductions in personal income tax that deliver the greatest proportional benefits to lower income earners. Depending on its objectives, the Government could combine these or other measures into alternative packages for tax reform.
38. The best use of revenue from extending the taxation of capital gains will ultimately depend on the Government's priorities. Tax reform is only one choice. The Government also has a wider set of options to consider beyond the tax system.
39. The Group recommends that the Government assess the options for tax reform against other needs and priorities to determine what would best enhance the wellbeing of New Zealanders.

## Potential packages for tax reform

35. A broad extension of the taxation of capital gains (as set out in Volume II) is projected to raise approximately \$8.3 billion over five years. The revenue is expected to increase over time, rising to a long-run average of 1.2% of gross domestic product (GDP) per annum, but it will also be volatile. In light of these revenue projections, Ministers have directed the Group to develop revenue-neutral packages of tax reform for the Government's consideration.
36. The Group has developed four illustrative packages:
- A package that increases progressivity through reductions in personal income tax.
  - A package with a greater focus on measures to support businesses and housing affordability.
  - A package with a greater focus on supporting savers, particularly those on lower incomes.
  - A package with a more diversified focus, where business tax measures are deferred to enable greater savings measures.

## Other opportunities to improve the tax system

40. The *Interim Report* contained recommendations on many other aspects of the tax system. Time constraints have precluded further in-depth investigation of these issues but the recommendations remain an essential part of the Group's prescription for reform.

## Matters requiring significant attention by the Government

### The future of work

41. The Group is concerned that the effectiveness of the pay as you earn (PAYE) withholding system will reduce if labour market changes increase the proportion of self-employed workers in the future. The Group therefore supports Inland Revenue's efforts to increase the compliance of the self-employed.
42. The Group also supports expanding the use of withholding taxes to increase compliance and recommends that withholding be extended as far as practicable (including to platform service providers, such as ride-sharing companies) so long as this does not impose unreasonable compliance costs.

## The integrity of the tax system

43. The integrity of the tax system requires constant vigilance. Tax avoidance erodes social capital. It is also fundamentally unfair, because it means that compliant taxpayers must pay more to make up for the lost revenue.
44. At the moment, there appears to be a set of integrity risks associated with the use of closely held companies. Some of the underlying problems derive from the fact that the company and top personal tax rates are not aligned but there is a clear need for Inland Revenue to strengthen enforcement of the rules for closely held companies. Extending the taxation of capital gains could also reduce integrity risks by reducing opportunities for tax planning and tax avoidance.
45. The Group also recommends further developing measures to reduce the extent of undeclared and cash-in-hand transactions (sometimes known as the 'hidden economy'). These measures could include increasing the reporting of labour income and even the removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.
46. Tax collection could be enhanced by increasing the remedies available to the Commissioner of Inland Revenue to address non-compliance. The Group recommends the use of departure prohibition orders and introducing a regime similar to Australia's Director Penalty Notice for serious cases, where the directors are the economic owners of the business and there has been persistent or intentional non-compliance.
47. The Group also recommends establishing a single Crown debt collection agency, to achieve economies of scale and more equitable outcomes across all Crown debtors.

## The administration of the tax system

48. The Group considers there is a need for greater public access to data and information about the tax system. Inland Revenue should review whether the information and data it currently collects offers the most useful insights or whether other datasets would better respond to the needs and interests of the public and future policy development. It is particularly important to have better data about the distribution of wealth in New Zealand.
49. The Group also considers there is a need to improve the resolution of tax disputes. The Group recommends establishing a taxpayer advocacy service to assist taxpayers in disputes with Inland Revenue and also wishes to ensure the Office of the Ombudsman is adequately resourced to carry out its functions in relation to tax.

## Tax technical capability

50. Inland Revenue must maintain deep technical expertise, alongside strategic policy capability. The Group strongly recommends that Inland Revenue continue to invest in the technical and investigatory skills of its staff. The Group also expects to see the Treasury playing a stronger role in the development of tax policy than it has in recent years.

## Matters requiring further work

### Charities

51. The Group received many submissions regarding the treatment of business income for charities and whether the tax exemption for charitable business income confers an unfair advantage on the trading operations of charities.
52. The Group considers that the underlying issue is more about the extent to which charities are distributing or applying the surpluses from their activities for the benefit of their charitable purposes.

53. The core question is whether the broader policy settings for charities encourage appropriate levels of distribution. In light of this, the Group recommends that the Government periodically review the charitable sector's use of what would otherwise be tax revenue, to verify that the intended social outcomes are actually being achieved.
54. Another area of concern relates to the treatment of private charitable foundations and trusts. The rules about these entities appear to be unusually loose. The Government should consider whether to apply a distinction between privately controlled foundations and other charitable organisations, with a view to removing concessions for privately controlled foundations or trusts that do not have arm's length governance or distribution policies.
55. The Group notes that the Government has launched a review of the Charities Act 2005. The Group has provided its analysis to Inland Revenue and the Department of Internal Affairs for further consideration as part of the Charities Review and the Tax Policy Work Programme.
58. One problematic aspect of GST relates to the treatment of financial services, which are not subject to GST for reasons of administrative complexity. The Group has considered a number of options for taxing the consumption of financial services but has not been able to identify a means of doing so that is both feasible and efficient. However, the Government should monitor international developments in this area.
59. The Group does not recommend introducing a financial transactions tax at this point.

### Corrective taxes

### Goods and services tax (GST)

60. A corrective tax is a tax that is intended to influence behaviour and lead to better health and wellbeing outcomes for New Zealanders. Outside of the environmental sphere, New Zealand currently levies corrective taxes on alcohol and tobacco.
61. Some submitters have suggested the development of a framework for deciding when to apply corrective taxes (similar to the framework developed by the Group for the use of environmental taxes). The Group supports this suggestion.
62. Detailed recommendations on the rates of alcohol and tobacco excise are beyond the expertise of the Group. However, the Group does recommend that the Government simplify the schedule of alcohol excise rates and is concerned about the distributional impact of further increases in tobacco excise beyond the increases that have already been scheduled.
63. The Group acknowledges widespread public interest in adopting a sugar tax. The case for a sugar tax must rest on a clear view of the Government's objectives. If the Government wishes to reduce the consumption of sugar across the board, a sugar tax is likely to be an effective response. If the Government wishes to reduce the sugar content of particular products, regulation is likely to be more effective. In either case, there is a need to consider the use of taxation, alongside other potential policy responses.
56. GST is an important source of revenue for the Government. Yet the Group has received many submissions calling for a reduction in the GST rate – or for the introduction of new GST exceptions – to reduce the impact of GST on lower-income households.
57. The Group acknowledges public concern about the regressive nature of GST but has decided not to recommend a reduction in the GST rate or the introduction of new GST exceptions. This is because other measures, such as increases in transfers or changes to the personal tax system, will increase progressivity more effectively than reductions to GST.

## Final words

64. Everyone has an opinion on tax. It is a subject that arouses strong passions and even deep disagreements – but it is also a way in which we come together as a society ('nāu te rourou, nāku te rourou') to contribute to our nation's broader prosperity ('ka ora ai te iwi'). Tax should matter to everyone.
65. Over the past year, thousands of New Zealanders have shared their thoughts on the future of the tax system. The Group deeply appreciates the generosity of all submitters who took the time to set out their views to us. The submissions have informed and also challenged us. Our recommendations are better for having received them.
66. The process of tax reform will now move into a different phase, as the Government picks up and considers our recommendations. In this new phase, it is vital that public input continues to influence the direction of tax reform.
67. To this end, the Group encourages all New Zealanders to stay involved as the programme of tax reform is developed. Together, we can – and should – shape the future of tax.

# Summary of recommendations

This chapter summarises the Group's final recommendations.

## Capital and wealth

1. The majority of the Group recommends a broad extension of the taxation of capital gains.<sup>4</sup>
2. If a broad extension of capital gains taxation were to occur, the Group recommends that it have the characteristics detailed in Volume II of this report. These characteristics are summarised below.

### *What to tax*

The Group:

- a) recommends including gains and most losses from all types of land and improvements (except the family home), shares, intangible property and business assets.
- b) recommends not including personal-use assets (such as cars, boats or other household durables).
- c) considers that some types of transactions relating to collectively owned Māori assets merit specific treatment in light of their distinct context.
- d) recommends that the Government engages further with Māori to determine the most appropriate treatment of transactions relating to collectively owned Māori assets.
- e) recommends that the existing rules continue to apply to foreign shares that are currently taxed under the fair dividend rate method of taxation, as well as anything taxed under the financial arrangement rules.

- f) recommends only taxing gains and losses that arise after the implementation date (Valuation Day).

### *When to tax*

The Group:

- g) recommends the tax be imposed on a realisation basis in most cases.
- h) recommends rollover treatment for certain life events (such as death and relationship separations), business reorganisations and small business reinvestment.

### *How to tax*

The Group:

- i) recommends that capital gains be taxed within the current income tax system and taxed at a person's marginal rates.
- j) recommends no discount for capital gains and no adjustment for inflation.
- k) recommends that capital losses be ring-fenced for: portfolio investments in listed shares (other than when they are trading stock); associated party transactions; and losses from Valuation Day assets.
- l) recommends that capital losses on privately used land be denied entirely.
- m) recommends that capital losses (other than those described in recommendations (k) and (l) above) be treated in the same way as other tax losses and taxpayers should generally be able to offset losses arising from the disposal of capital assets against ordinary taxable income.

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4 Three members of the group (Hodge, Hope and Oliver) do not support a broad extension.

### *Transitional rules*

The Group:

- n) recommends that taxpayers have five years from Valuation Day (or to the time of sale if that is earlier) to determine a value for their included assets as at Valuation Day.
- o) recommends that if no valuation is determined, then a default rule apply. (See Volume II for default valuation methods.)
- p) encourages the Government and Inland Revenue to develop tools and guidance to further assist taxpayers through the Valuation Day process.

### *Development and implementation*

The Group:

- q) recommends that Inland Revenue be fully resourced and has the capability to develop and implement the new tax.
  - r) encourages Inland Revenue to develop low-cost options for valuations required outside of Valuation Day that are sufficiently robust to maintain the integrity of the system.
  - s) recommends that the policy and legislative processes include thorough consultation with a diverse range of voices, using both formal and informal channels.
  - t) recommends that the policy and legislative process includes coverage of the following issues:
    - i) Identifying further options for reducing the compliance costs.
    - ii) Ensuring that the final rules do not create a bias in favour of investment in foreign shares.
    - iii) Assessing whether there is a need for information reporting or withholding requirements for capital gains – and, if so, how widely to impose them.
3. The Group does not recommend introducing a wealth tax.
4. The Group does not recommend introducing a land tax.

## **Environmental and ecological outcomes**

5. The Group recommends the Government adopts the framework in Chapter 4 of this report for taxing negative environmental externalities.

### **Greenhouse gases**

The Group:

6. supports a reformed Emissions Trading Scheme (ETS) remaining the centrepiece of New Zealand's emissions reduction efforts but recommends it be made more 'tax-like' – specifically, by providing greater guidance on price and auctioning emissions units to raise revenue (as recommended by the Productivity Commission).
7. recommends periodic review of the ETS to ensure it is fit for purpose and is the best mechanism for pricing greenhouse gas emissions.
8. recommends that all emissions face a price, including from agriculture, either through the ETS or a complementary system.

### **Water abstraction and water pollution**

The Group:

9. recommends greater use of tax instruments to address water pollution and water abstraction challenges if Māori rights and interests can be addressed.
10. recommends further development of tools and capabilities to estimate diffuse water pollution to enable more accurate and effective water pollution tax instruments.
11. recommends introducing input-based tax instruments, including on fertiliser, if significant progress is not made in the near term on implementing output-based pricing measures or other regulatory measures.

### **Solid waste**

The Group:

12. supports the Ministry for the Environment's review of the rate and coverage of the Waste Disposal Levy.

13. supports expanding the coverage of the Waste Disposal Levy.
14. recommends a reassessment of the negative externalities associated with landfill disposal in New Zealand to ascertain if a higher levy rate is appropriate.
15. recommends a review of hypothecation arrangements of the Waste Disposal Levy to ensure funds are being used in the most effective way to move towards a more circular economy.

## Transport

16. The Group supports current reviews by the Government and Auckland Council into introducing congestion pricing.

## Concessions

The Group:

17. recommends costs associated with the care of land subject to a QEII covenant or Ngā Whenua Rāhui be tax deductible.
18. recommends that the Government consider allowing employers to subsidise public transport use by employees without incurring fringe benefit tax.
19. recommends that the Government review various tax provisions specific to farming, forestry and petroleum mining with a view to removing concessions harmful to natural capital, while also considering new concessions that could enhance natural capital.

## Other matters relating to environmental taxation

The Group:

20. recommends some or all of environmental tax revenue should be used to help fund a transition to a more sustainable, circular economy.
21. recommends consideration over the longer term of new tools, like an environmental footprint tax, or a natural capital enhancement tax.
22. recommends the Government strengthen its environment tax capabilities, including with the Parliamentary Commissioner for the Environment.

23. recommends that the Government commission incidence studies to better understand who will incur the costs of new environmental taxes and to design appropriate mitigation measures.
24. recommends further work to rigorously assess how taxes can complement other environmental policy measures and to work through the design principles identified in the Group's framework for taxing negative environmental externalities.

## The taxation of business

The Group recommends that the Government:

25. retain the imputation system.
26. not reduce the company tax rate at the present time. However, the Government should continue to monitor developments in company tax rates around the world, particularly in Australia.
27. not introduce a progressive company tax.
28. not introduce an alternative basis of taxation for smaller businesses, such as cashflow or turnover taxes.
29. retain the 17.5% rate for Māori authorities.
30. extend the 17.5% rate to the subsidiaries of Māori authorities.
31. consider technical refinements to the Māori authority rules, as suggested by submitters, in the Tax Policy Work Programme.
32. change the loss-continuity rules to support the growth of innovative start-up firms.
33. reform the treatment of black-hole expenditure, with:
  - a) a new rule to recognise deductions for expenditure incurred by businesses that is not otherwise dealt with under the Income Tax Act 2007, including in respect of abandoned assets and projects.
  - b) a clawback of tax deductions where an abandoned asset or project is subsequently restored, such that those deductions would be capitalised.
  - c) the spreading of black-hole expenditure over five years.

- d) a safe-harbour threshold of \$10,000 to allow upfront deductions for low levels of feasibility expenditure.
34. subject to fiscal constraints, consider restoring depreciation deductions for buildings if there is an extension of the taxation of capital gains. To manage the fiscal costs, the Government could reinstate building depreciation on a partial basis for:
- seismic strengthening only
  - multi-unit residential buildings
  - industrial, commercial and multi-unit residential buildings.
35. consider tax measures that encourage building to higher environmental standards.
36. consider developing a regime that encourages investment into nationally-significant infrastructure projects.
37. examine the following options to reduce compliance costs:

***For immediate action:***

- a) Increase the threshold for provisional tax from \$2,500 to \$5,000 of residual income tax.
- b) Increase the closing stock adjustment from \$10,000 to \$20,000-\$30,000.
- c) Increase the \$10,000 automatic deduction for legal fees and potentially expand the automatic deduction to other types of professional fees.
- d) Reduce the number of depreciation rates and simplify the process for using default rates.

***Subject to fiscal constraints:***

- e) Simplify the fringe benefit tax and simplify (or even remove) the entertainment adjustment.
- f) Remove resident withholding tax on close company-related party interest and dividend payments, subject to integrity concerns.
- g) Remove the requirement for taxpayers to seek the approval of the Commissioner of Inland Revenue to issue GST Buyer Created Tax Invoices.

- h) Allow special rate certificates and certificates of exemption to be granted retrospectively.
- i) Increase the period of validity for a certificate of exemption or special rate certificate.
- j) Remove the requirement to file a change of imputation ratio notice with Inland Revenue.
- k) Extend the threshold of 'cash basis person' in the financial arrangement rules, which would better allow for the current levels of personal debt.
- l) Increase the threshold for not requiring a GST change-of-use adjustment.

***The Government should also review and explore the following opportunities:***

- m) Adjust the thresholds for unexpired expenditure and for the write off of low-value assets.
- n) Help small businesses reduce compliance costs through the use of cloud-based accounting software.
- o) Consider compensation for withholding agents if additional withholding tax obligations are imposed.
- p) Review the taxation of non-resident employees.
- q) Review whether the rules for hybrid mismatches should apply to small businesses or simple business transactions.

38. The Group recommends that the Government give favourable consideration to exempting the New Zealand Superannuation Fund from New Zealand tax obligations.

## International income taxation

The Group:

39. supports New Zealand's continued participation in discussions at the OECD on the future of the international income tax framework.

40. recommends that the Government stand ready to implement a digital services tax if a critical mass of other countries move in that direction and it is reasonably certain New Zealand's export industries will not be materially impacted by any retaliatory measures.
41. recommends that the Government actively monitor developments and collaborate with other countries with respect to equalisation taxes.
42. recommends that the Government ensure, to the extent possible, that New Zealand's double tax agreements and trade agreements do not restrict New Zealand's taxation options in these matters.

## Retirement savings

The Group:

43. recommends that the Government, depending on its priorities, consider encouraging the savings of low-income earners by carrying out one or more of the following:
  - a) Refunding the employer's superannuation contribution tax (ESCT) for KiwiSaver members earning up to \$48,000 per annum. This refund would be clawed back for KiwiSaver members earning more than \$48,000 per annum, such that members earning over \$70,000 would receive no benefit.
  - b) Ensuring that a KiwiSaver member on parental leave would receive the maximum member tax credit regardless of their level of contributions.
  - c) Increasing the member tax credit from \$0.50 per \$1 of contribution to \$0.75 per \$1 of contribution. The contribution cap should remain unchanged.
  - d) Reducing the lower portfolio investment entity (PIE) rates for KiwiSaver funds (10.5% and 17.5%) by five percentage points each.
44. recommends that the Government consider ways to simplify the determination of the PIE rates (which would apply to KiwiSaver).

## Personal income tax

45. The Group's recommendations on personal income tax are dependent on the objectives of the Government.
  - a) If the Government wishes to improve incomes for very low-income households, the Group considers the best means of doing so will be through welfare transfers.
  - b) If the Government wishes to improve incomes for certain groups of low- to middle-income earners, such as full-time workers on the minimum wage, the Group considers changes to personal income taxation may be a better option.

The Group:

46. recommends that the Government consider increases in the bottom threshold of personal tax to increase the progressivity of the personal tax system.
47. recommends that the Government consider combining increases in the bottom threshold with an increase in the second marginal tax rate.
48. suggests that if this higher tax rate is adopted, the Government consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase.
49. prefers increasing the bottom threshold to introducing a tax-free threshold.
50. recommends that the Government consider an increase in net benefit payments to ensure beneficiaries receive the same post-tax increase as other people on the same income.
51. recommends that the Government consider changes to tax rates and thresholds alongside any recommendations made by the Welfare Expert Advisory Group.
52. recommends that the Government not reduce the top marginal tax rate on vertical equity grounds because it is already low by international standards and it would not increase progressivity of the tax system.

53. notes that many submissions called for increasing top personal tax rates in order to enable policies that would make a material reduction in income inequality through the personal tax system. As such increases are precluded by the Group's Terms of Reference the Group did not undertake an analysis of the options (and their effectiveness).

## Future of work

The Group recommends that the Government:

54. support Inland Revenue's efforts to increase the compliance of the self-employed, particularly expanding the use of withholding tax as far as practicable, including to platform providers, such as ride-sharing companies.
55. support the facilitation of technology platforms to assist the self-employed meet their tax obligations through the use of 'smart accounts' or other technology-based solutions.
56. continue (through Inland Revenue's current work) to use data analytics and matching information for specific taxpayers to identify under-reporting of income.
57. review the current GST requirements for contractors who are akin to employees.
58. align the definitions of employee and dependent contractors for tax and employment purposes.
59. provide more support for childcare costs, though the Group considers this support is best provided outside of the tax system.

## Integrity of the tax system

The Group recommends:

60. a review of loss trading, potentially in tandem with a review of the loss-continuity rules for companies.
61. that, for closely held companies, Inland Revenue have the ability to require a shareholder to provide security to Inland Revenue if:
  - a) the company owes a debt to Inland Revenue.
  - b) the company is owed a debt by the shareholder.

- c) there is doubt as to the ability/and or the intention of the shareholder to repay the debt.
62. further action in relation to the hidden economy, including:
  - a) an increase in the reporting of labour income (subject to not unreasonably increasing compliance costs on business).
  - b) a review of the measures recently adopted by Australia in relation to the hidden economy, with a view to applying them in New Zealand.
  - c) the removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.
63. that Inland Revenue continue to invest in the technical and investigatory skills of its staff.
64. further measures to improve collection and encourage compliance, including:
  - a) making directors who have an economic ownership in the company personally liable for arrears on GST and PAYE obligations where there has been deliberate or persistent non-compliance (as long as there is an appropriate warning system).
  - b) departure prohibition orders.
  - c) aligning of the standard of proof for PAYE and GST offences.
65. the establishment of a single centralised Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.
66. that Inland Revenue strengthen enforcement of rules for closely held companies.
67. that the Government explore options to enable the flexibility of a wider gap between the company and top personal tax rates without a reduction in the integrity of the tax system.

## Administration of the tax system

The Group:

68. recommends that the Government:
  - a) fund oversampling of the wealthy in existing wealth surveys.

- b) include a question on wealth in the census.
  - c) request Inland Revenue to regularly repeat its analysis of the tax paid by high wealth individuals.
  - d) commission research on using a variety of data sources on capital income, including administrative data, to estimate the wealth of individuals.
69. strongly encourages the Government to release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available). The Government could consider further measures to increase transparency as public attitudes change over time.
70. encourages Inland Revenue to publish or make available a broader range of statistics, in consultation with potential users, either directly or (preferably) through Stats NZ.
71. encourages Inland Revenue to collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.
72. recommends that any further expansion of the resources available to the Ombudsman include consideration of provision for additional tax expertise and possibly support to manage any increase in the volume of complaints relating to the new Crown debt collection agency proposed by the Group.
73. recommends establishing a taxpayer advocacy service to assist with the resolution of tax disputes.
74. recommends that the Government consider a truncated tax disputes process for small taxpayers.
75. recommends the use of the following principles in public engagement on tax policy:
- a) Good faith engagement by all participants.
  - b) Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Crown/Māori Relations).
  - c) Earlier and more frequent engagement.
  - d) The use of a greater variety of engagement methods.
  - e) Greater transparency and accountability on the part of the Government.
76. notes the need for the Treasury to play a strong role in tax policy development, and the importance of Inland Revenue maintaining deep technical expertise and strategic policy capability.
77. encourages the continuing use of purpose clauses where appropriate and recommends including an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.

## Charities

### The Group:

78. recommends that the Government periodically review the charitable sector's use of what would otherwise be tax revenue, to verify that intended social outcomes are being achieved.
79. supports the Government's inclusion of a review of the tax treatment of the charitable sector on its Tax Policy Work Programme, as announced in May 2018.
80. notes that the income tax exemption for charitable entities' trading operations was perceived by some submitters to provide an unfair advantage over commercial entities' trading operations.
81. notes, however, that the underlying issue is the extent to which charitable entities are accumulating surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities.
82. recommends that the Government consider whether to apply a distinction between privately controlled foundations and other charitable organisations.
83. recommends that the Government consider whether to amend the deregistration tax rules to more effectively keep assets in the sector or to ensure there is no deferral benefit through the application of these rules.

84. recommends that the Government review whether it is appropriate to treat some not-for-profit organisations as if they were final consumers or, alternatively, to limit GST concessions to a smaller group of non-profit bodies, such as registered charities.
85. recommends that the Government consider whether the issues identified by the Group in relation to charities have been fully addressed or whether further action is required, following the conclusion of the review of the Charities Act 2005.

## GST and financial transaction taxes

The Group:

86. recognises the significant public concern regarding GST but does not recommend a reduction in the rate of GST. This is because lowering the GST rate would not be as effective at targeting low- and middle-income families as either:
- a) welfare transfers (for low-income households), or
  - b) personal income tax changes (for low- and middle-income earners).
87. does not recommend removing GST from certain products, such as food and drink, on the basis that the GST exceptions are complex, poorly targeted for achieving distributional goals and generate large compliance costs. Furthermore, it is not clear whether the benefits of specific GST exceptions are passed on to consumers.
88. considers there is a strong in-principle case to apply GST to financial services but there are significant impediments to a workable system. The Government should monitor international developments in this area.
89. does not recommend applying GST to explicit fees charged for financial services.
90. recognises that there is active international debate on financial transaction taxes, which should be monitored but does not recommend the introduction of a financial transactions tax at this point.

91. has already reported to Ministers on the issue of GST on low-value imported goods and the Government recently introduced a Bill in December 2018 advancing proposals to address the issue.<sup>5</sup>

## Corrective taxes

The Group:

92. supports the development of a framework for deciding when to apply corrective taxes (similar to the framework developed by the Group for the use of environmental taxes).
93. recommends that the Government review the rate structure of alcohol excise with the intention of rationalising and simplifying it.
94. recommends that the Government prioritise other measures to help people stop smoking before considering further large increases in the tobacco excise rate beyond the increases currently scheduled.
95. recommends that the Government develop a clearer articulation of its goals regarding sugar consumption and gambling activity.

## Housing

The Group:

96. recommends that the Productivity Commission inquiry into local government financing considers a tax on vacant residential land.
97. considers that residential vacant land taxes would be best levied as local taxes rather than a national tax.
98. recommends that the 'ten-year rule' which taxes a gain from the sale of property where the property has increased in value due to changes in land use regulation be repealed.
99. recommends that disclosure of the purchaser's IRD number on the Land Transfer Tax Statement should be required when purchasing a main home.

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<sup>5</sup> Taxation (Annual Rates for 2019-20, GST Offshore Supplier Registration and Remedial Matters) Bill.

# 1

## The purposes of tax

1. Over the past year, the Tax Working Group has engaged in a national conversation with New Zealanders about the future of the tax system. Thousands of New Zealanders – including iwi, businesses, unions and other organisations – have shared their thoughts and had their say on the future of tax.
2. The views and suggestions have differed from submission to submission. Yet the Group has been struck by the depth of interest and passion expressed by all submitters on the issues before us. It is clear that tax matters to everyone.
3. There is good reason for the passion we have seen. If the ultimate purpose of public policy is to improve wellbeing, then few areas of public policy contribute as much to the wellbeing of New Zealanders as the tax system.
4. There are three main ways in which the tax system supports the wellbeing of New Zealanders:
  - **A fair and efficient source of revenue.** Taxes provide revenue for the Government to fund the public goods and services that underpin our living standards. The tax system thus represents a way in which citizens come together to channel resources for the collective good of society.
  - **A means of redistribution.** Taxes fund the redistribution that allows all New Zealanders, regardless of their market income, to participate fully in society. While much of this redistribution occurs through the transfer system, the progressive nature of income tax means that the tax system also plays a role in reducing inequality.
  - **A policy instrument to influence behaviours.** Taxes can also be used as an instrument to achieve specific policy goals by influencing behaviour. Taxes influence behaviour by changing the price of goods, services or activities; taxes can discourage certain activities and favour others. In this way, taxes can complement – or even replace – traditional policy tools, such as regulation and spending. This may be particularly important in the health and environmental spheres.
5. In light of these perspectives, the Group has decided to take a rounded view on the purpose of the tax system. The tax system is essential as a source of revenue to the Government – but it is also an important tool that can be used positively to pursue distributional goals, shape behaviour, improve living standards and develop sustainably. The Group has been alert to these multiple purposes in developing its recommendations.



# 2

## Frameworks for assessing tax policy

1. The Group considers it is important to bring a broad conception of wellbeing and living standards to its work on the tax system. This approach reflects the composition of the Group, which includes members with a diverse range of skills and experience, including perspectives from beyond the tax system.
2. Many factors affect living standards and many of these factors have value beyond their contribution to material comfort. Only a subset of those values can be captured in monetary terms but non-monetary factors are key determinants of wellbeing and living standards. As an example, certain types of economic activity may increase material comfort but reduce wellbeing overall, if the by-products of that activity degrade the natural environment.
3. To measure wellbeing comprehensively, income measures must therefore be supplemented with measures of other factors, such as health, connectedness, security, rights and capabilities, and environmental and ecological sustainability. In the *Interim Report* the Group applied three perspectives for assessing the full range of impacts from tax policy: the Treasury's Living Standards Framework, Te Ao Māori perspectives, and the established principles of tax policy design.
4. These frameworks complement each other. A combination of these frameworks also led the Group to develop a specific framework for deciding when to use taxation to achieve environmental and ecological outcomes. (This framework is discussed in Chapter 4.)

### The Living Standards Framework

5. The Living Standards Framework identifies four capital stocks that are crucial to wellbeing: financial and physical capital, human capital, social capital and natural capital. Wellbeing depends on the sustainable development and distribution of the four capitals, which together represent the comprehensive wealth of New Zealand.
6. The Living Standards Framework encourages policymakers to explore how policy change affects the four capitals. It widens the scope of analysis to include a more comprehensive range of factors, distributional perspectives and dynamic considerations. In this way, the Living Standards Framework is consistent in intent with international wellbeing frameworks, such as the United Nation's Sustainable Development Goals (Ormsby 2018).

### Te Ao Māori perspectives on wellbeing and living standards

7. The Group has also been working with Māori academics and experts to develop a framework that draws on principles from Te Ao Māori, the Living Standards Framework and the principles of tax policy design, to arrive at a more holistic view of wellbeing.

8. As discussed in the *Interim Report*, this prototype framework is centred on the concept of waiora. Waiora is commonly used in Te Ao Māori to express wellbeing; it comes from the word for water (wai) as the source of all life. Accordingly, the framework is called He Ara Waiora – A Pathway towards Wellbeing.
9. He Ara Waiora draws on four tikanga principles: manaakitanga (care and respect); kaitiakitanga (stewardship/guardianship); whanaungatanga (the relationships/connections between us); and ōhanga/whairama (prosperity). These principles support the preservation and sustainable development of the four capitals of the Living Standards Framework.
10. During the Group’s engagement with Māori academics and experts, Associate Professor Mānuka Henare proposed that these tikanga sit within an integrated framework that incorporates a clear sense of purpose, as well as guidance for how policy is developed and implemented, and performance and accountability measures. Figure 2.2 illustrates what such an integrated framework might look like.
11. In this framework, the concept of waiora or wellbeing would be encapsulated in kawa. This moral imperative in supporting wellbeing could be grounded in the ‘Āta noho’ principle from the preamble of the Māori text of Te Tiriti o Waitangi (the Treaty of Waitangi) – meaning that the moral imperative for the tax system could be that all New Zealanders live a life they value, with specific recognition of Māori living the lives that Māori value and have reason to value.<sup>6</sup> The four tikanga identified in figure 2.1 map across to the principles, ethics and values in figure 2.2, while the ritenga and āhuatanga in figure 2.2 are areas that require further development to enable practical application and understanding of impact.
12. The importance of addressing each level of this framework was reinforced in discussions in a series of hui in October. The Group heard broad support for the intent of the work as a meaningful reflection of Te Tiriti o Waitangi, reflecting our continuing maturation as a nation. While the provenance of tikanga resides with Māori, values that are derived from tikanga have a strong resonance with contemporary New Zealand. However, participants suggested that further work is needed to preserve the integrity of the use of tikanga when applied to policy. There should also be awareness and careful navigation of the range of understandings of tikanga in different contexts and places in the country.
13. There was also a view that a tikanga framework should have a broad ambit, rather than just focus on tax – because its value will come from the extent to which it improves the lives of Māori and all New Zealanders.
14. In light of this feedback, discussions have begun with the Treasury about how He Ara Waiora might inform the evolution of the Living Standards Framework. A discussion paper on the future development of He Ara Waiora will be released to keep the public informed on this progress.
15. The process around He Ara Waiora is only just beginning. The Group looks forward to seeing how this work influences policy over time.

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<sup>6</sup> The preamble of the Māori text of Te Tiriti states, “kia tohungia ki a ratou o ratou rangatiratanga me to ratou wenua, kia mau tonu hoki te Rongo ki a ratou me te Atanoho hoki”. This is translated in principle as the desire “to preserve to them their full authority as leaders (rangatiratanga) and their country (to ratou wenua) and that lasting peace (Te Rongo) may always be kept with them and continued life as Māori people (Atanoho hoki)”, (Henare, 1988).

Figure 2.1: He Ara Waiora – A Pathway towards Wellbeing

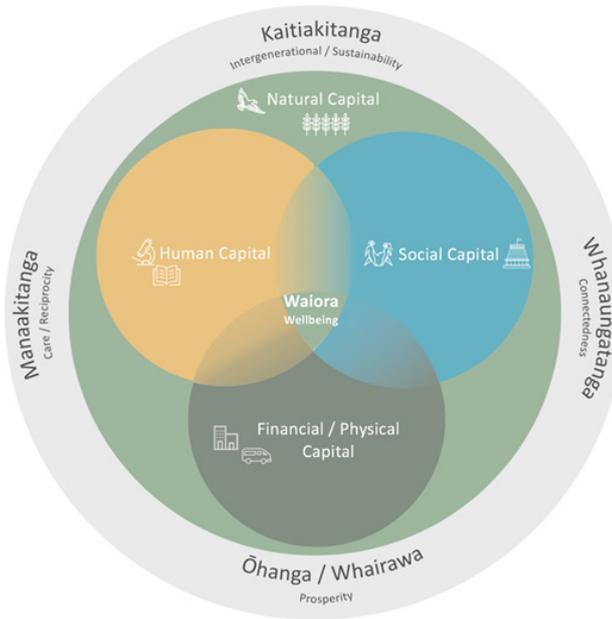
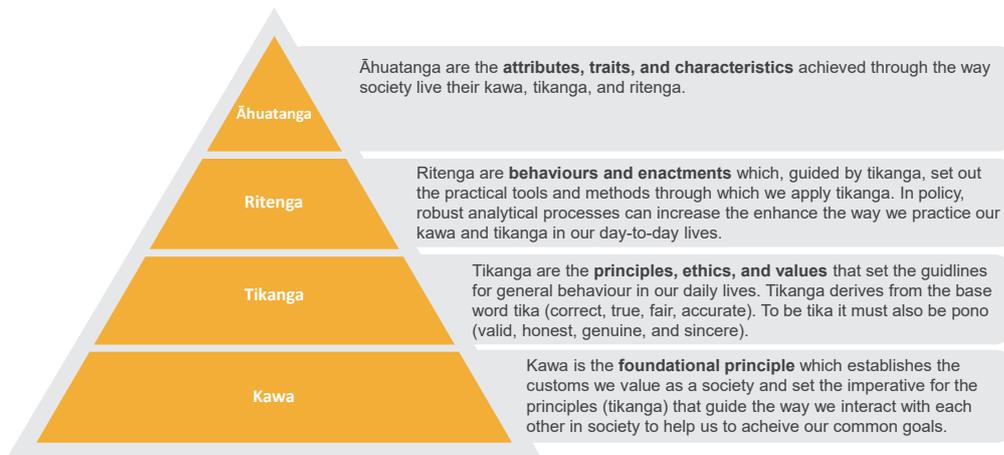


Figure 2.2: A proposed integrated framework



Source: The Treasury (2018)

## The established principles of tax policy design

16. Previous tax reviews, in New Zealand and elsewhere, have used a relatively consistent set of principles to assess the design of the tax system. These principles are:

- **Efficiency** – minimising impediments to economic growth and avoiding distortions to the use of resources.
- **Equity and fairness** – achieving fairness, including through enhancements to ‘horizontal equity’ (the principle that people with similar income and assets should pay the same amount in taxes) and ‘vertical equity’ (the principle that those with higher income or assets should pay higher amounts of tax). Procedural fairness is also important for a tax system.
- **Revenue integrity** – minimising opportunities for tax avoidance and arbitrage.
- **Fiscal adequacy** – raising sufficient revenue for the Government’s requirements.

- **Compliance and administration costs** – minimising the costs of compliance and administration and giving taxpayers as much certainty as possible.
- **Coherence** – ensuring that individual tax rules make sense in the context of the entire tax system.

17. Two further important principles in the tax system are *predictability* and *certainty* – meaning that taxpayers should be able to understand clearly what their obligations are before those obligations are due.

18. The Group considers these principles remain valid and useful in assessments of the tax system, particularly when considering the costs and benefits of options for reform. These principles complement the system’s perspective offered by a broader living standards analysis. In turn, the other frameworks discussed in this chapter will help policymakers interpret and apply these principles in the future.

# 3

## The structure, fairness and balance of the tax system

1. Over the past year, the Group has carefully examined the tax system to form a view about its overall structure, fairness and balance.
2. These are subjective concepts and there are different ways to work towards a judgement on them. The Group has borne the following questions in mind in the course of its work:
  - Does the tax system treat income consistently, no matter how it is earned and in which sectors it is earned?
  - Does the tax system minimise opportunities for tax avoidance?
  - Are the bases of the tax system likely to be sustainable over time?
  - Should taxation be used as a tool to influence behaviour?
3. The *Submissions Background Paper* began the process by setting out the main features of the tax system, while the *Interim Report* provided the Group's initial views on these features. This chapter presents the Group's final assessment on the structure, fairness and balance of the tax system.

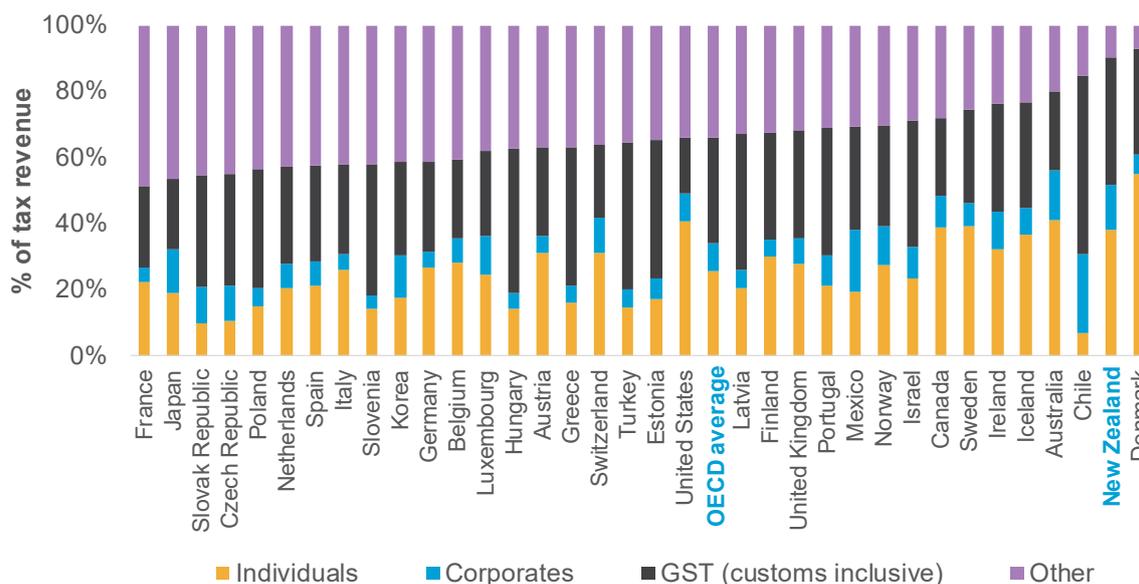
### Key features of the tax system

4. In the *Interim Report*, the Group highlighted two distinctive features of the tax system – its reliance on a relatively narrow range of taxes and its relative lack of progressivity (compared to other developed countries).

### The range of taxation

5. New Zealand's current tax system is underpinned by a tax policy framework known as 'broad base, low rate'. In a broad-based system, there should be few exceptions to the base on which the tax is levied. The benefit of a broad-based system is that it allows the Government to raise substantial amounts of revenue at relatively low rates of taxation.
6. The tax system relies on income tax (mainly personal and company) and goods and services tax (GST). The broad base, low rate framework applies to each of these taxes. New Zealand raises about 90% of its tax revenue from these two taxes. Corrective taxes, such as tobacco and alcohol excise, are the third largest source of revenue.
7. Compared to other developed countries, however, New Zealand makes little use of other sources of taxation, such as environmental taxes and social security levies. Thus, while the taxes levied by New Zealand have broad bases, the overall range of taxation is relatively narrow.
8. New Zealand's treatment of capital gains is also distinctive. Unlike other developed countries, New Zealand does not generally tax capital gains.
9. The most significant gains currently outside the tax net are gains from the sale of land and housing (other than by developers, dealers or speculators), shares (other than portfolio investments in non-resident companies), business goodwill and intellectual property, in cases where those assets have been acquired for a purpose other than sale.

Figure 3.1: Source of tax revenue across OECD countries (2015)



Source: OECD

**New Zealand’s approach to the taxation of capital gains**

New Zealand’s income tax law is founded on a distinction between ‘revenue’ gains and expenditure, which are taxed and deductible and ‘capital’ gains and expenditure, which are not taxed and non-deductible.

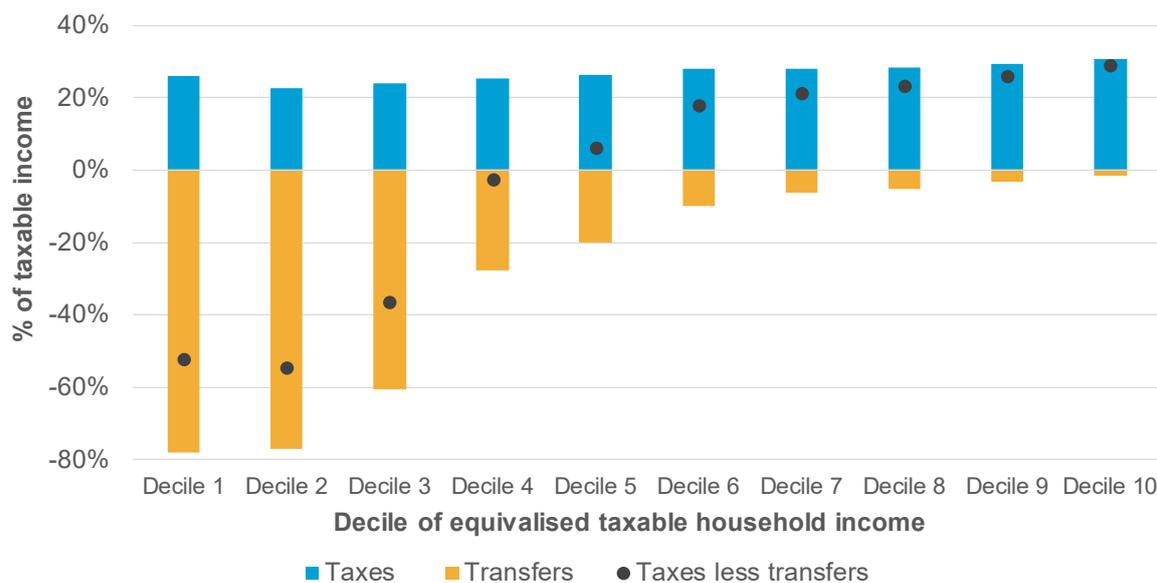
In principle, gains derived in the ordinary course of carrying on a business – or with the intention of making a gain – are income and are taxable. Other non-systematic gains are generally not taxed. In practice, however, it is often difficult to draw this distinction, because the particular rules require judgements about a person’s intentions, the nature of their business and the role of a particular asset, liability or payment within that business.

10. As the following section elaborates, the current treatment of capital gains reduces the progressivity of the tax system.

## Distributional outcomes

- Overall, relative to other OECD countries, the tax system is not particularly progressive. Figure 3.2 illustrates this point by showing tax and transfers as a percentage of taxable income. This figure shows that there is not a significant increase in average effective tax rates across taxable income deciles, even though the amount of tax paid increases by decile. The average rate of income tax paid by households ranges from 23% for lower income households, to 31% for higher-income households. Progressivity is instead largely delivered through transfers, such as Working for Families.
- It is also important to note that the inequality-reducing power of the tax and transfer system has *fallen* over the last three decades (Nolan 2018, Perry 2017). This outcome reflects the fact that the tax system and the transfer system have both become less effective at reducing inequality.

Figure 3.2: Taxes and transfers, by income decile (2012/13)



Note: Taxable income excludes, by definition, untaxed capital gains. Tax is calculated for the purpose of this figure as the sum of income tax, GST and Accident Compensation Corporation (ACC) levies. Estimated using the Treasury’s model of the tax and welfare system and Household Economic Survey 2012/13 data.

Source: The Treasury

13. It is difficult to compare distributional outcomes across countries, because the results will be affected by the features of each economy, as well as choices about which taxes are included in the analysis. According to the OECD, however, New Zealand’s tax and transfer system reduces income inequality by less than is the case in Australia or, on average, across OECD countries (see figure 3.3).

## Problems, challenges and opportunities

14. The outcomes generated by the tax system reflect deep structural choices about what is taxed and what is *not* taxed. Two issues have been particularly prominent in the Group’s discussions over the past year: the treatment of capital gains and the treatment of stocks of natural capital. In the Group’s view, these structural choices have significant impacts on the fairness and balance of the tax system as a whole.

## The treatment of capital gains

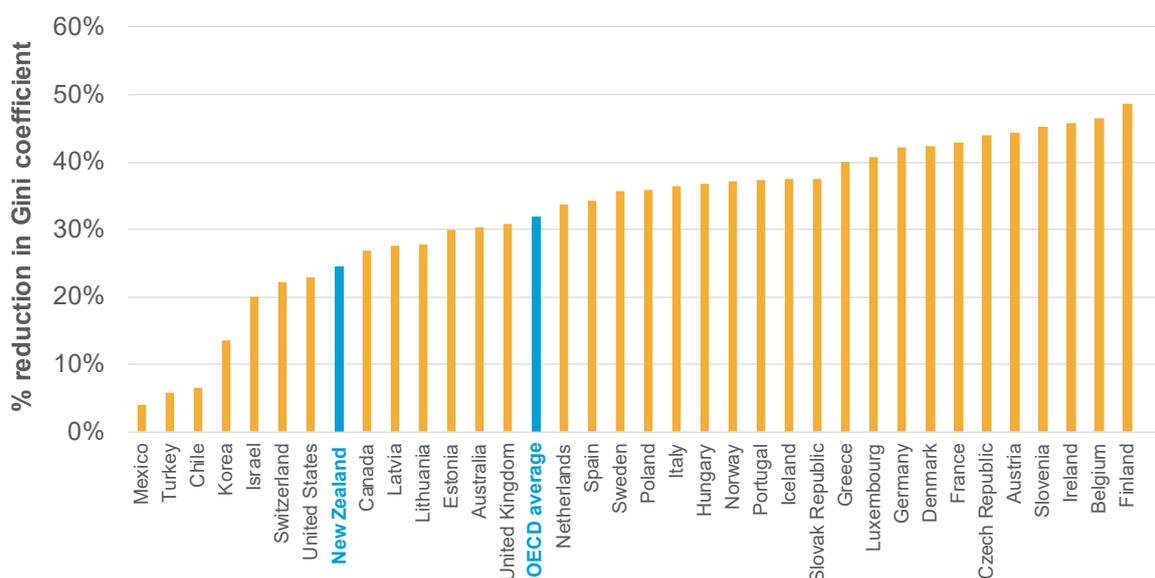
15. The current treatment of capital gains creates a set of interlinked problems.

### *Equity and fairness*

16. A sense of fairness is central to maintaining public trust and confidence in the tax system. This is because a system that distributes the costs of taxation in a way that is perceived to be unfair will generate resentment and undermine social capital.

17. The inconsistent taxation of capital gains is unfair. It means that people earning the same amount of income can face quite different tax obligations, depending on whether their income is earned as capital gains or, say, as wages.

Figure 3.3: Reduction in income inequality on account of the tax and transfer system across OECD countries (2014/15)



Note: Estimated as the percentage difference in the Gini coefficient of income inequality before and after taxes and transfers. This figure is based on the OECD Income Distribution database. It includes personal income taxes, employees' social security contributions and cash transfers but excludes payroll taxes and value-added taxes such as GST.

Source: OECD

18. The resulting outcomes are also regressive. The distribution of net wealth is concentrated in the top 20% of households (see figure 3.4) and is even more concentrated when owner-occupied housing is excluded. This indicates that the distribution of untaxed capital gains is also likely to be quite skewed. Evidence from countries with capital gains taxes indicates that high-income people derive a much greater share of their income from capital gains than low- and middle-income people.

### How does the treatment of capital gains affect our tax obligations?

#### Example 1

This year, Oliver earned \$50,000 in wages. He will pay \$8,020 in tax on this income.

Judy, on the other hand, earned \$25,000 of taxable income from part-time work. She also sells shares in a business and received a non-taxable capital gain of \$25,000. Judy has also earned \$50,000 but under current law, Judy will pay \$3,395 in tax.

#### Example 2

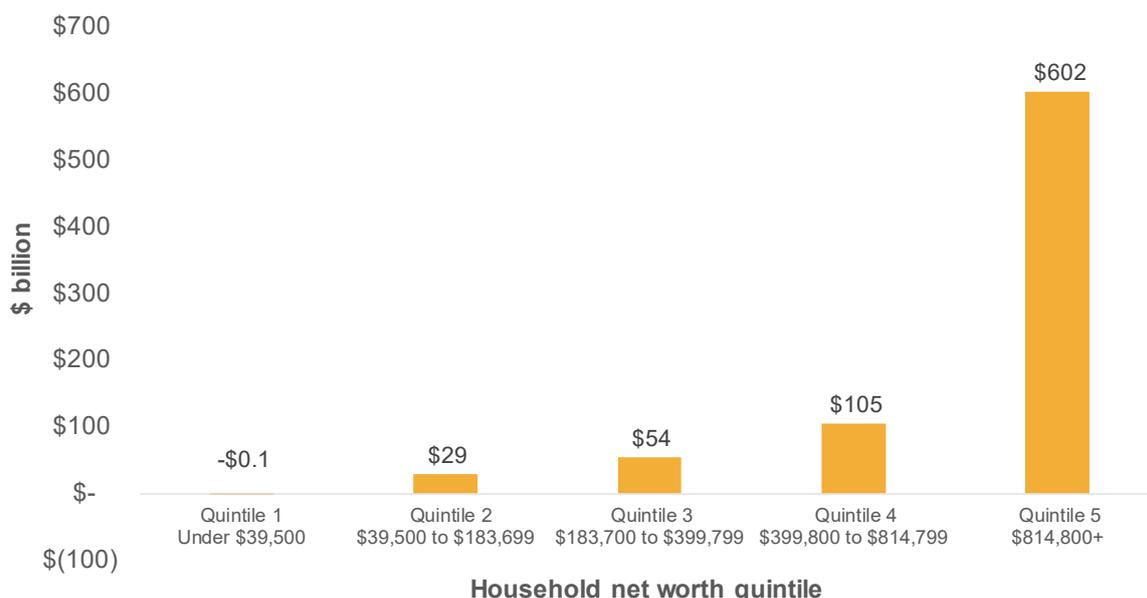
Paul earns a salary that roughly corresponds to the median New Zealand wage. Over the last ten years, he has earned about \$450,000 of income from his job. He has paid tax of approximately \$70,000 on that income.

Paul's friend Art purchased some residential property 10 years ago. He has been managing the property on a break-even basis by renting it to tenants and claiming deductions for maintenance, mortgage payments and rates.

Art recently sold this property, making a gain of \$195,000. (This gain roughly corresponds to the difference in median New Zealand house prices across the 10-year period.) He is not subject to any tax on this gain under current tax rules, as the gain is of a capital nature.

19. The inconsistent taxation of capital gains therefore has the effect of reducing the proportion of tax paid by the wealthiest members of our society.

Figure 3.4: Total net worth (excluding owner-occupied housing), by net worth quintile (2015)



Note: Net worth estimates exclude owner-occupied housing. Quintiles are based on household net worth including owner-occupied housing.

Source: Stats NZ (Household Economic Survey 2015)

20. The Group is concerned that the resulting perceptions of unfairness will erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance that underpins efficient tax collection.

### *Integrity*

21. The current approach reduces the integrity of the tax system because it creates opportunities and incentives for tax minimisation and avoidance. Taxpayers have a strong incentive, for example, to argue that their gains are on capital account and are therefore not taxable.

22. Other tax minimisation strategies – such as dividend avoidance – also take advantage of the inconsistent taxation of capital gains. These types of integrity risks sharpen perceptions of unfairness and further erode social capital.

23. It is often difficult to establish the boundary between capital gains and ordinary income. For example, take a person who spends a couple of months renovating a residential investment property and then sells the property for a substantial gain. A large portion of the gain will reflect the return on the person's labour. In the current system, however, it is likely to be treated as an untaxed capital gain.

24. In the case of certain sales of assets, the administration of the tax system is hampered by the need for subjective tests to assess the purpose or intention of those sales. These tests can create uncertainty for taxpayers when attempting to determine their tax obligations. Little revenue is collected, even with a bright line rule. This may also reflect problems with enforcement.

### *Fiscal adequacy and sustainability over time*

25. As the population ages, a greater proportion will live off capital income in retirement. Together with the impact of technological change, this is likely to increase the capital intensiveness of the economy and the ratio of capital income to labour income.

26. A tax system that is more sustainable over time – and that is fair in an intergenerational sense – will need to draw much more upon capital income in the future. Capital gains can be an important component of this income.

27. A broader tax base would also provide more flexibility to respond to future challenges. At present, the gap between the company rate and the top personal rate is small but there are still integrity problems, with people using company structures and tax-free gains to lower their effective tax rates. These pressures will only grow if the company rate is lowered or the top personal rate is raised in the future.
28. At the same time, an increased dependence on capital gains taxation will create a revenue risk, particularly in relation to the treatment of capital losses. These issues are considered further in Chapter 5 *Extending the taxation of capital gains*.

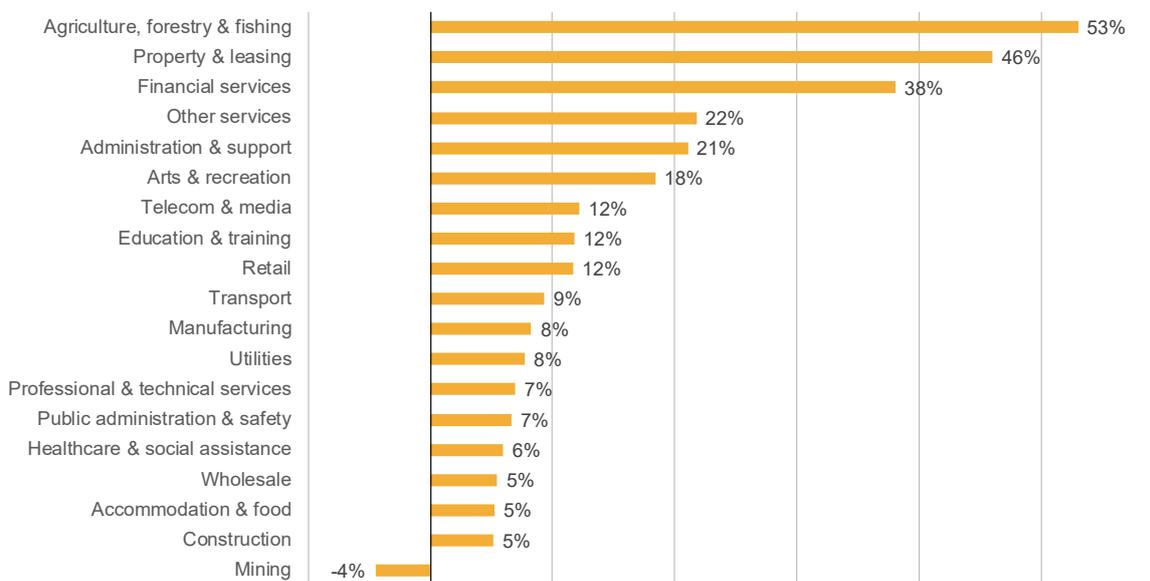
### Efficiency and productivity

29. The efficiency impacts of the current approach are difficult to establish. Yet it is clear that the inconsistent taxation of capital gains does affect the tax obligations facing different sectors of the economy. This, in turn, could affect productivity by distorting decisions about the allocation of savings and investment.
30. The data on capital gains by sector is incomplete. The key piece of available data comes from the IR10 filings of small-to-medium enterprises (which are defined as having annual turnover of less

than \$80 million). There are significant caveats to this data source. It does not capture capital gains earned by large companies, by the Government, or by managed funds. It understates untaxed capital gains from the financial sector and from residential investment properties. It also covers a relatively short time period; data over a longer time period is not available.

31. Nevertheless, the data is suggestive. Figure 3.5 shows the proportion of accounting profit by industry that is an untaxed realised capital gain. In broad terms, the main industries where untaxed capital gains represent a high proportion of total accounting profit are: agriculture, forestry and fishing; property and leasing services; and financial services. For most other manufacturing and service sectors, untaxed capital gains represent around 10% or less of total accounting profits. These outcomes (at least in some of the sectors) reflect the substantial increases in land values over the past 20 years.
32. Since capital gains are untaxed, there is a tax incentive to invest in those industries that have a high proportion of untaxed realised gains. To put it more bluntly, the tax system is subsidising the activities of these industries.

Figure 3.5: Untaxed realised gains as a proportion of total accounting profit by industry (2013-2017)



Source: Inland Revenue (IR10 data)

## The treatment of natural capital

33. This chapter has thus far assessed the structure, fairness and balance of the tax system from a traditional perspective. A broader perspective would consider the relationship between natural capital and the tax system and acknowledge natural capital as a profound and non-substitutable basis for the economy. It would also recognise that natural capital is productive in its own right; even 'unused' or 'vacant' land, for example, produces a stream of ecosystem services that underpin human existence.
34. Natural capital is not prominent in current conceptions of tax systems in New Zealand or other developed countries. New Zealand also makes little use of environmental taxation, other than excise duty on fuel and road-user charges. New Zealand ranked 30th out of 33 OECD countries for environmental tax revenue as a share of total tax revenue in 2013 (OECD, 2018). There is little consideration of natural capital impacts in the development of tax policy and no reporting on the environmental impacts of tax policy.
35. There is also a strong revenue argument to increase the use of environmental taxation. As with capital gains, expanding environmental taxation would increase the flexibility and sustainability of the tax base over time. The additional revenue could be used to respond to increasing demands for public services or it could be recycled into measures that support a transition towards a more sustainable economy.
36. Given the non-substitutable nature of natural capital, the declining state of New Zealand's environment, and the increasing fiscal costs of mitigation and adaptation, the Group sees a compelling case to broaden the tax base and make greater use of environmental taxation.

## Opportunities to improve the tax system

37. The Group has spent much time discussing the treatment of capital income and of natural capital but it has also looked across the tax system as a whole. Beyond the issues identified in this chapter the Group has identified a raft of opportunities to improve the structure, fairness and balance of the tax system.
38. These include measures to increase progressivity, boost productivity and reduce compliance costs for small businesses. In addition, the Group has examined the gaps and behaviours that give rise to the 'hidden economy' and has identified measures to improve integrity and boost tax collection. The Group has also identified opportunities to increase transparency, strengthen taxpayer rights and improve policy development – particularly so that a more diverse range of voices can help to shape the system.
39. The challenges and opportunities in these areas were first explored in the *Interim Report* and are summarised in Chapter 9 of this report.

## Summary assessment

40. Over the past year, the Group has carefully examined the tax system in order to form a view about its overall structure, fairness and balance. Although the tax system has many strengths, the Group has found that the tax system is not particularly progressive and relies on a relatively narrow range of taxes (although the taxes that are levied by New Zealand have broad bases).
41. The outcomes generated by the tax system reflect deep structural choices about what is taxed and what is *not* taxed. Two issues have been particularly prominent in the Group's discussions: the treatment of capital gains and the treatment of stocks of natural capital. In the Group's view, these structural choices have significant impacts on the fairness and balance of the tax system as a whole.
42. The current treatment of capital gains reduces the fairness, progressivity and integrity of the tax system. Yet it is not enough to identify a problem:

it is also necessary to identify a solution. The Group also acknowledges there are important choices and judgements involved in dealing with these problems – and that the extent to which the problems are dealt with effectively depend greatly on the details of policy design.

43. Chapter 5 *Extending the taxation of capital gains* outlines the Group's preferred approach to dealing with these problems. In devising these recommendations, the Group has been very alert to the risk that, with poorly designed policy, the costs can outweigh the benefits.

44. There are also clear opportunities to increase the use of environmental taxation. The Group has prioritised considerations of environmental taxation during the course of its work. Chapter 4 *Environmental and ecological outcomes* sets out the Group's framework for deciding when to apply environmental taxes. It also shows how the tax system could be developed, over time, to enhance natural capital.

# 4

## Environmental and ecological outcomes

1. The wellbeing of New Zealanders is critically dependent on the state of our natural environment and the health of our ecosystems. The Living Standards Framework reflects this relationship, including natural capital as one of the four capitals affecting wellbeing. Natural capital refers to all aspects of the natural environment needed to support life and human activity.
2. Chapter 2 *Frameworks for assessing tax policy* explores how Te Ao Māori perspectives can inform our understanding and application of the Living Standards Framework, which includes natural capital. Waiora – which is commonly used in Te Ao Māori to express wellbeing – centres our conception of wellbeing in wai (water) as the source of all life. As human beings, we are largely comprised of water and we draw our sustenance from the natural environment. Our wellbeing is inextricably linked to the wellbeing of our natural capital. Our success in managing ourselves in relation to these natural systems and resources will determine the sustainability and wellbeing of our people over time.
3. Owing to the symbiotic relationship of all things in the natural world, there is mutual benefit in responsible management of ourselves in relation to natural resources. From a tikanga perspective, kaitiakitanga (stewardship/guardianship) encapsulates our obligations to undertake responsible resource management of our natural capital, as a basis for the sustainable development of our human, social and physical and financial capitals. Extending the principles of kaitiaki to the way we manage these four capitals collectively can support our approach to achieving wellbeing for our environment and our people.
4. It is also important to acknowledge that the natural environment has intrinsic value that goes beyond utility, because our sense of who we are as people is deeply embedded in our connection to it. Through manaakitanga (care and respect) we are incentivised to practise kaitiakitanga and our whanaungatanga (relationships to each other) are enhanced.
5. These values are not exclusive to Te Ao Māori. It is evident from public submissions that many New Zealanders are deeply concerned about the state of the environment. Their concerns cover effects at the local, national and global levels including pollution in our waterways, declining biodiversity, threats to our coastal zones and the impacts of climate change.
6. The Group has been tasked to respond to these concerns by examining the role the tax system can play in delivering positive environmental and ecological outcomes, especially over the longer term.

### Environmental challenges

7. There are urgent environmental problems facing both New Zealand and the globe. Climate change is an especially critical threat. The Intergovernmental Panel on Climate Change (IPCC) has found that if global warming is to be limited to 1.5°C, rapid and far-reaching transitions in energy, land, infrastructure and industrial systems will be required (Intergovernmental Panel on Climate Change, 2018). In the OECD, New Zealand is among the highest emitters of greenhouse gases per dollar of GDP (OECD, 2014).

8. Other environmental challenges are both linked to and extend well beyond, climate change. Biodiversity loss is especially concerning. The global population of vertebrate animals has declined by 58% since 1970 (WWF, 2018). In New Zealand, native biodiversity has rapidly declined and continues to be threatened, especially on private land – New Zealand now has one of the highest proportions of native species at risk. Nearly 75% of native forests and 90% of wetlands have been cleared or drained, although protections have had a significant impact in stemming the loss of native forest (Ministry for the Environment, 1997; Stats NZ, 2018b). A review of 71 rare ecosystems in New Zealand found that 45 of them were threatened with extinction (Stats NZ, 2015).
9. Surface water use is under pressure in many parts of the country. 72% of native freshwater fish species are now threatened by, or at risk of, extinction and approximately 30% of our waterways fail the Government's standard for being swimmable (Ministry for the Environment and Stats NZ, 2017). Nitrate levels have generally worsened at monitored water sites for the period 2005-14, although phosphorous levels have improved (Ministry for the Environment and Stats NZ, 2017).
10. There are also challenges in our oceans. New Zealand administers a marine area of approximately four million square kilometres but only 0.3% of this area is classified as marine reserve (Ministry for the Environment, 2008). New Zealand has one of the largest and most comprehensive fishing quota systems in the world to maintain fish stocks. Nonetheless, 17% of fish stocks are deemed to be overfished and 6% have collapsed (Ministry for Primary Industries, 2018).
11. In summary, our natural capital is losing its capacity to produce the ecosystem services that we depend on.

## System goals and principles

12. These environmental challenges call for profound changes to the structure of economic activity. Policymakers will need to think in terms of systems change – and develop a set of goals and principles that can guide a transition, in the short and long term, to more sustainable patterns of economic activity.
13. Under traditional economic approaches, environmental challenges are often approached from a cost perspective. A transition will be expensive unless benefits and pathways to possible solutions are constructively mapped.
14. The Living Standards Framework and Te Ao Māori perspectives can support and enrich the transition towards greater systems thinking. Mātauranga Māori already contains knowledge systems and frameworks that reflect a holistic and interconnected view of the natural world and its resources.
15. The circular economy envisages a system in which we minimise the extraction and use of new material and energy resources, maximise the value of resources that are in use and then recover and regenerate resources at the end of their service life.<sup>7</sup> Tikanga, such as kaitiaki and manaaki, and mātauranga Māori more broadly, can help facilitate transitions that move towards more sustainable management practices like the circular economy. Observations of sustainable resource management have formed the basis of these knowledge systems, which are preserved in mātauranga Māori and tikanga values. Fully utilising the different knowledge systems of Aotearoa/New Zealand will improve on what we currently have and accelerate our potential to achieve our collective resource management, sustainability and development goals.

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<sup>7</sup> Similar economic approaches include ecological economics, transitioning economics, regenerative economics, sharing economics and doughnut economics.

16. These connections between healthy ecosystems and human wellbeing are also reflected in the United Nation's Sustainable Development Goals (SDGs). The SDGs are signed by all United Nations (UN) member states, including New Zealand and provide a set of timebound goals across all domains of wellbeing. In the environmental sphere, the goals set targets for clean water (SDG6), climate action (SDG13), life below water (SDG14) and life on land (SDG15). The SDGs provide one blueprint for defining and measuring a just transition over time.
17. The Group notes that many of these goals and concepts are already beginning to inform the public debate on the future of the economy, including through the Living Standards Framework. The Group encourages further efforts to develop a shared vision about the goals and pathways towards an 'Aotearoa Economy' that can be sustained within a safe ecological operating space.

## The role of the tax system – a vision for the short, medium and long term

18. As outlined in Chapter 1 taxation is not simply a means of raising revenue. Tax can also be used as an instrument to achieve specific policy goals by influencing behaviour. The Group considers the tax system can play an expanded role in New Zealand's environmental policy, helping to change behaviours and fund the transition towards a more regenerative, circular economy.
19. The Group has taken a broad view of taxes for assessing their role in improving environmental and ecological outcomes. The Group's working definition of an environmental tax is *an economic instrument that can be potentially revenue-raising for central or local government and that can improve environmental and ecological outcomes*.<sup>8</sup> The definition encompasses nationally uniform taxes or levies, locally variable taxes or levies and tradeable emissions permits for national and local markets where the permits are sold by the Government.
20. In the short term (the next 1 - 5 years) the Group recommends better use of environmental taxes to price negative environmental externalities. Environmental taxes can be a powerful tool for ensuring people and companies better understand and account for the impact of their actions on the ecosystems on which they depend.
21. Tax will not always be the right tool to address environmental externalities. The Group has therefore developed a framework to help decide when tax should be part of the policy response to environmental challenges – see *When to apply environmental taxes*. Using this framework, this chapter explores five specific areas for better deployment of environmental taxes: greenhouse gas emissions; water pollution; water abstraction; solid waste; and road transport.

### What are externalities?

In economics, an externality is a cost or benefit that falls upon an unrelated third party. One example of a negative environmental externality is air pollution from an industrial plant that reduces air quality in a neighbouring district: the residents in that district may have no connection to the industrial plant but nevertheless suffer the effects of the downwind air pollution.

Externalities can also be positive. For example, a restored wetland might provide flood protection for the surrounding area and also improve water quality. Social and ecological enterprises also produce positive externalities.

22. The Group also recommends removing tax concessions that are harmful to natural capital – see *Tax concessions* later in the chapter for the Group's recommendations about specific provisions.
23. In the medium term (the next 5 - 10 years) environmental tax revenue should be used to help fund a transition to a more sustainable economy – see *The medium term – revenue recycling* later in this chapter for further discussion.

<sup>8</sup> Environmental outcomes could be improved by encouraging behaviour change and/or by funding environmental improvements, mitigation works or assisting people through change.

24. In the longer term (the next 10 - 30 years) the Group considers there is scope for environmental taxes to broaden New Zealand's current tax base, sitting alongside income tax, GST and excise taxes. This could be underpinned by innovative new tools to measure and value environmental impacts, such as an environmental footprint tax or a natural capital enhancement tax – see *Longer-term opportunities – an extension of the tax base*. It could also be supported by expanded use of taxes on both renewable and non-renewable resources use.

## Environmental taxes in New Zealand

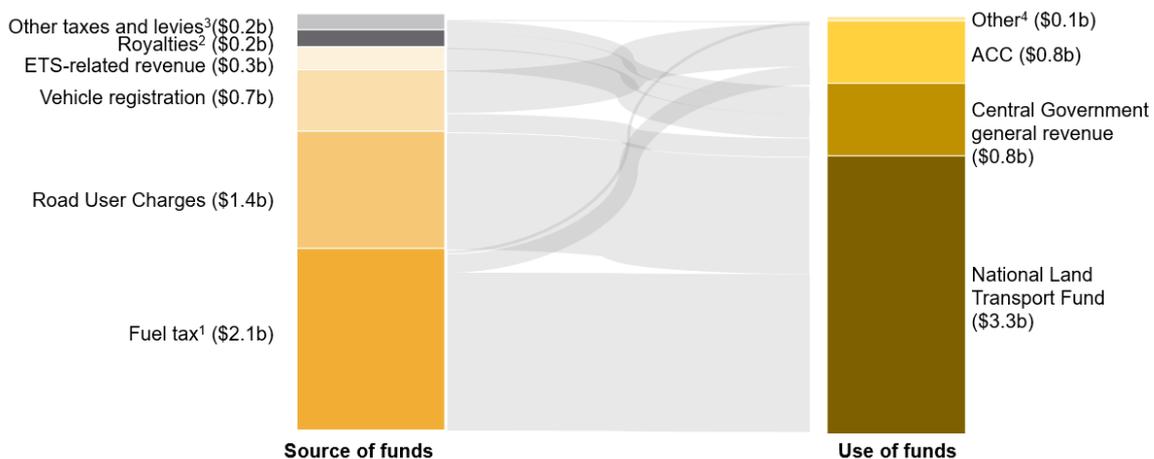
25. Stats NZ estimates that in 2016, the Government raised approximately \$5 billion in environmental taxes, as defined by the System of Environmental Economic Accounting (SEEA). This was equivalent to 6.2% of tax revenue, up from 4.8% in 1999 (Stats NZ, 2018a). Compared to other countries, New Zealand is a relatively low user of environmental taxes. New Zealand

ranked 30th out of 33 OECD countries for environmental tax revenue as a share of total tax revenue in 2013 (OECD, 2018).

26. Figure 4.1 shows the sources and uses of New Zealand's environmental tax revenue. Most of this revenue comes from taxes that are actually levied for non-environmental purposes: fuel taxes, road-user charges and vehicle registration fees make up over 80% of environmental tax revenue. These taxes are largely hypothecated to the National Land Transport Fund to pay for land transport infrastructure, or to ACC to provide compensation for road-related injuries.

27. Only a small share of environmental tax revenue comes from pollution taxes (such as the Waste Disposal Levy) or resource taxes (such as energy resource levies). This mix of environmental tax revenue is similar to other countries. Across all OECD countries with data, a majority of environmental tax revenue comes from transport and energy taxes, with relatively little from other pollution and resource taxes.

Figure 4.1: Sources and uses of environmental tax revenue in New Zealand (2016)



Notes: 1) Includes customs import duties. 2) Royalties are included in this figure but are typically excluded from environmental tax estimates as they are considered the sale of an asset. 3) Includes energy resource levies, the Waste Disposal Levy and other energy and resource taxes. 4) Includes local authorities and the Waste Minimisation Fund. 5) Numbers may not add owing to rounding.

Source: Stats NZ, the Treasury

# Framework for taxing negative environmental externalities

Taxation can be used as a tool to enhance natural capital when unpriced externalities lead to the over-exploitation of resource stocks and degrade the integrity of ecosystems.

*Favourable attributes:* The case for using taxation is stronger if one or more of the following criteria are met:

- *Behavioural responsiveness:* The level of damaging activity is relatively responsive to feasible price signals (i.e. it is relatively price elastic). If the damaging activity is relatively price inelastic, a tax might still be desirable as compensation to society for the costs being imposed and as a means of raising revenue.
- *Revenue-raising potential:* Large revenues could be raised from the tax, allowing for the reduction of more distortionary taxes and/or spending on other government priorities.
- *Diversity of responses:* There is a range of potential abatement responses with differing costs, including investment in innovation, such that regulating a particular response could impose high costs.

*Essential attributes:* The suitability of taxation as a policy instrument – relative to other instruments, such as regulation and spending – can be assessed through the following criteria:

- *Measurability:* The damaging activity, or a reasonable proxy of it, can be measured.

- *Risk tolerance:* There is sufficient time for a tax instrument to be developed and refined.
- *Sufficient scale:* The environmental problem is sufficiently large-scale and persistent to justify administration and compliance costs in comparison to regulation.

## Principles for designing externality taxes

The principles of tax policy design described in Chapter 2 of this report can also apply to environmental taxes (including compliance and administration costs). Building off these, there are seven design principles that warrant particular attention:

1. *Māori rights and interests* must be acknowledged and addressed.
2. *Distributional impacts* should be assessed and mitigated.<sup>9</sup>
3. The suite of responses should reflect the full *cost of externalities*.<sup>10</sup>
4. The price should *vary locally* where there is local variation in impacts.
5. *International linkages* should be considered, including international obligations and agreements.
6. The tax should be *integrated with other policy*, complementing other regulatory responses.
7. *Intertemporal fairness* should be considered to ensure that resources are used in a way that is fair to future generations and other species.

9 Mitigation measures could include complementary changes to tax and transfer settings.

10 Where the only response is a tax, the tax should be set to reflect the cost of the externality. However, part of the cost might be best managed by regulation, insurance policy or some other measure. The cost of externalities can be difficult to estimate. However, a tax that is 50% above or below the true cost will still likely perform well in terms of welfare gains (Parry, Norregaard, & Heine, 2012). In situations where certain externalities cannot be costed, the price of the tax may need to be set higher than the costed externalities to allow for uncosted externalities.

28. The Group has also found that New Zealand has limited institutional capability to design and implement environmental taxes – a concern also raised by submitters. The Group recommends that the Government strengthen its capability to use tax to enhance environmental and ecological outcomes. This includes support for the Parliamentary Commissioner for the Environment, which should be resourced to provide independent advice on the environmental tax work of the Government.

## When to apply environmental taxes

29. Taxation can be a tool to change behaviour but it is not always the best tool. Sometimes, regulation or spending may be more effective tools; in other cases, taxation may be complementary. As has been stressed by public submitters, tax should not be considered in isolation when dealing with the environment. Instead, the merits of tax as a policy instrument should be assessed, together with the merits of other tools and approaches.
30. Over the past months, the Group has developed a framework for deciding when to apply taxes to address negative environmental externalities, building off the approaches outlined in Chapter 2 *Frameworks for assessing tax policy*. This framework, which is presented above, sets out the circumstances in which taxation is likely to be an effective tool and the characteristics of a well-designed externality tax.
31. This framework provides only limited guidance on the type of tax instrument to use. As noted above, the Group has taken a broad view of potential tax instruments. Where there is a case for taxing environmental externalities, different instruments should be reviewed. This includes fixed-rate emission charges and tradeable emission permits.
32. The Group has given more limited consideration to the taxation of natural resource use (or resource rents). There are some existing frameworks in New Zealand that have been used to shape the royalty regimes for petroleum and minerals (Ministry of Business, Innovation and Employment (MBIE) 2012). Future

assessments should also include consideration of intertemporal fairness, ensuring resources are used in a way that is fair to future generations of people, as well as other species.

## The short term – negative externalities and concessions

33. The Group has considered changes to the tax system that would enhance environmental and ecological outcomes in the short term, using its framework for taxing negative externalities.
34. The Group wishes to highlight five specific areas for further attention in the short term: greenhouse gas emissions, water pollution, water abstraction, solid waste and road transport.
35. The following discussion focuses on criteria in the negative externality framework which are only partially met and on design principles of particular relevance to each resource.
36. The Group has also considered changes to tax concessions – both the removal of existing concessions that harm natural capital and the introduction of new concessions to support natural capital. These are discussed below as part of possible short-term tax changes.

## Greenhouse gas emissions

### *Evaluation against the framework*

37. Greenhouse gases generally meet the criteria of the Group's framework, suggesting they are well suited to the use of tax instruments (where tax instruments include auctioned tradeable emission permits). Of particular note is the wide range of abatement opportunities. This means abatement of emissions is likely to be achieved at a lower cost by using taxation than by mandating particular actions through regulation. There is also evidence that putting a price on greenhouse gas externalities drives innovation in abatement (Dechezlepretre, Martin & Bassi, 2016).
38. Greenhouse gases could be a significant source of revenue over the medium term and New Zealand already has an environmental tax tool for pricing some greenhouse gas emissions in the New Zealand Emissions Trading Scheme (ETS).

39. The Group's framework also highlights potential challenges with applying tax instruments to greenhouse gases. The main challenges relate to measurement, international linkages and pricing.

### **Measurement**

40. Greenhouse gas emissions from diffuse sources, such as biological sources in agriculture, are more difficult to estimate accurately than point-source emissions from fossil fuels.<sup>11</sup> This has been an important issue in expanding the ETS to include agriculture.

41. There are different approaches to measuring agricultural greenhouse gas emissions. At the more precise end of the spectrum, there are modelling tools such as OVERSEER that attempt to estimate greenhouse gas emissions accounting for farm-specific characteristics. These tools can be expensive to administer but account for some differences in farm management practices. At the less precise end of the spectrum, there are approaches such as processor-level charges<sup>12</sup>. These approaches are simpler to administer and encourage some mitigation but do not reflect differences in farming management practices.

42. There is still much work to do on this issue but the Group notes that even imprecise approaches could provide a useful price signal that accounts for land use and intensity decisions.

### **International linkages**

43. If New Zealand imposes the full cost of carbon but other countries do not, there is a perceived risk of 'emissions leakage' – production reduces here and expands in countries with weaker climate action, with no net global reduction in emissions (Levinson & Taylor, 2008).

44. At a minimum, this points to the importance of supporting globally coordinated action, including United Nations Climate Change Conference agreements (the most recent being COP24). There are also policy options for mitigating leakage risks. These options include transitional assistance for impacted industries, targeted revenue recycling, and regulation to level the carbon playing field between domestic producers and importers.

45. There are economic and social benefits from taking faster action on climate change. It could encourage innovation and reduce the cost of meeting New Zealand's international commitments.

### **The Emissions Trading Scheme and pricing**

46. As noted above, New Zealand already has a tool for pricing carbon through the ETS.<sup>13</sup> A major criticism of the ETS is that it has significantly underpriced carbon.<sup>14</sup> The Productivity Commission reports that New Zealand's emissions price (approximately \$NZ20/t-CO<sub>2</sub>e in 2018) will need to rise to at least \$75/t-CO<sub>2</sub>e (and possibly to more than \$200/t-CO<sub>2</sub>e) over the next few decades if New Zealand is to achieve its international commitments (NZPC, 2018).

47. There is scope to address the weaknesses of the ETS. Some reforms have already taken place – for example, the removal of the one-for-two policy.<sup>15</sup> The Group also notes a range of reforms recommended by the Productivity Commission: these include introducing mechanisms that provide guidance about the path of future emissions prices, and the auctioning of emissions units (NZUs) to achieve this (NZPC 2018). The ETS could also raise the same amount of revenue as a carbon tax if free allocation were eliminated.

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11 Diffuse source pollution (or nonpoint source pollution) is pollution from widespread or dispersed sources, such as pasture run off from animal wastes and fertilisers, as well as run off from paved surfaces in urban areas.

12 For example, charging on a per-litre-of-milk basis, using an estimate of the average quantity of greenhouse gas emissions embedded in a litre of milk.

13 A carbon tax is another economic instrument that could be used to price emissions.

14 Stiglitz-Stern estimate the Paris Agreement objectives require a pricing corridor of \$US40-80/t-CO<sub>2</sub>e in 2020 and \$US50-100/t-CO<sub>2</sub>e in 2030 (Stern & Stiglitz, 2017). This is roughly equivalent to \$NZ58-116/t-CO<sub>2</sub>e in 2020 and \$NZ73-145/t-CO<sub>2</sub>e in 2030. Biological emissions – almost half of New Zealand's total emissions – are also excluded from the ETS.

15 The one-for-two transitional measure allows non-forestry businesses to pay one emissions unit for every two tonnes of CO<sub>2</sub>e emissions.

48. Retaining the ETS also supports policy stability and durability. It is sensible to take advantage of the existing infrastructure around the ETS. It is also important to give stability about the long-term direction of policy, so that businesses and individuals have the confidence to invest in emissions abatement.
49. The Group supports an emissions pricing regime with comprehensive coverage, including of agriculture. However, the Group does not have a view on whether this is best done inside the ETS or through other pricing approaches.
- Revenue potential**
50. The Government does not currently auction emissions units but could generate significant revenue by doing so.
51. The revenue potential of greenhouse gas emissions depends on policy choices about the treatment of biological emissions and limits to free allocation. The Secretariat for the Tax Working Group has modelled revenue scenarios based on carbon budget forecasts from the Ministry for the Environment (MfE).
52. Under current settings and assuming the NZU price rises to \$50/t-CO<sub>2</sub>e in 2030, the auction of NZUs is forecast to raise approximately \$130 million per annum over the coming decade.
53. If agriculture faces a charge for 5% of its emissions, and free allocation is reduced linearly by one percentage point each year, revenue will roughly double to \$240 million per annum, assuming no change in emission volumes.
54. If free allocation is reduced by three percentage points each year (the upper end of the broad-based reduction rates being considered by other countries), and this same reduction rate is also applied to agriculture, revenue will double again to \$530 million per annum.
55. The total revenue that could be raised by removing all free allocation is estimated to be \$2.1 billion per annum, assuming no change in emissions volumes. This is equivalent to replacing the ETS with a comprehensive carbon tax, assuming prices are the same.
56. Revenue will be sensitive to the emissions price. If the price rises to \$80/t-CO<sub>2</sub>e in 2030 (the highest rate in scenarios used by the Productivity Commission), revenue will increase by approximately 40% above the estimates in the table. At \$30/t-CO<sub>2</sub>e (the lowest rate in Productivity Commission scenarios) revenue will decrease by approximately 27%.

**Table 4.1: Fiscal potential from auctioning emissions units**

	Share of biological emissions charged for	Change in free allocation, relative to current rates	Average annual forecast revenues, 2021-30
<b>Status quo</b>	0%	0%	\$130 million
<b>Scenario 1</b>	5%	Reduction of 1%-point p.a.	\$240 million
<b>Scenario 2</b>	5% in 2021, increasing 3%-points p.a.	Reduction of 3%-points p.a.	\$530 million
<b>Scenario 3</b>	10% in 2021, increasing 5%-points p.a.	Reduction of 5%-points p.a.	\$830 million

Note: The modelling is based on current MfE carbon budget projections. It assumes no change in emission volumes as a result of changes in free allocation or biological emission charging, and also assumes a linear increase in the emissions price from \$20/t-CO<sub>2</sub>e in 2021 to \$50/t-CO<sub>2</sub>e in 2030. These price paths do not reflect the Group's views on the appropriate price of carbon – as noted in this report, prices above \$200/t-CO<sub>2</sub>e may be needed to achieve New Zealand's carbon reduction targets. The fiscal impact of higher prices will depend on the accompanying change in emissions volumes.

Revenue forecasts are preliminary and indicative.

Source: Ministry for the Environment, Secretariat for the Tax Working Group

57. Greenhouse gas emissions may not be a reliable tax base in the long term if New Zealand substantially reduces its net emissions. In the short-to-medium term, however, even modest changes to the ETS settings could raise reasonable amounts of revenue.

### **Assessment**

58. Greenhouse gases are well suited to the use of tax instruments. However, there are significant shortcomings in the current pricing and coverage of emissions in New Zealand.

59. The Group supports a reformed ETS remaining the centrepiece of New Zealand's emissions reduction efforts but recommends it be made more 'tax-like' – specifically, by providing greater guidance on price and auctioning NZUs to raise revenue (as recommended by the Productivity Commission). The Group also supports pricing agricultural emissions.

60. The Group is not well placed to take a view on specific ETS settings, such as the appropriate settings of a price band to drive the desired behaviour change. The work of the Interim Climate Change Committee and future Climate Commission will be important in ensuring that the ETS establishes a credible and enduring price signal to de-carbonise the New Zealand economy.

61. The Group recommends periodic review of the ETS to ensure it is fit for purpose and is the best mechanism for pricing greenhouse gas emissions.

## **Water pollution**

### **Evaluation against the framework**

62. The pollution of fresh waterways is a significant environmental problem in New Zealand. A range of pollutants reduce water quality, including nitrogen, phosphorous, sediment and pathogens, such as E. coli. Water pollutants come from both rural and urban sources (MfE 2017).

63. Applying our framework to water pollution, a number of criteria are only partially met. Output measurement of diffuse pollutants is challenging and modelling of some water pollutants is more difficult than others. Opportunities for abatement will vary by catchment, as will the environmental benefits. Risk tolerance may have been exhausted in some catchments and it may be necessary to ban discharges to restore those waterways to healthy states. In designing potential tax instruments, consideration of Māori rights and interests will be critical, as will pricing and equity issues. Measurement and pricing issues are further explored below.

### **Measurement**

64. There are significant measurement challenges for water pollutants and a range of approaches to measuring and estimating emissions.

65. Direct measurement of diffuse pollutants (e.g. by the use of probes) can be expensive and difficult to relate back to specific emission sources.

66. Input-based approaches measure emission-producing inputs (e.g. fertiliser use). Inputs are generally easier to measure but can be poor proxies for actual emissions and environmental impacts.

67. There are also output-based modelling approaches, such as OVERSEER. OVERSEER was designed as an on-farm nutrient budgeting and management tool. It has also been used for estimating some types of nutrient run off (notably nitrogen) for environmental management purposes.

68. The Group acknowledges concerns raised by a range of submitters about OVERSEER, including transparency, ownership and accuracy, especially for some types of emissions.<sup>16</sup> The Group welcomes the recent findings of Parliamentary Commissioner for the Environment, which highlights current limitations of OVERSEER as a regulatory tool. The Group supports further development of a broad range of modelling and measuring tools.

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<sup>16</sup> The technical capacity of OVERSEER to model sediment, pathogens and phosphorous run off, as well greenhouse gas emissions, is significantly less advanced than for nitrogen run off.

69. The better the measurement, the clearer the price signal is to reduce harmful emissions. Nonetheless, tax instruments based on relatively coarse estimates may be better than the status quo for some pollutants, such as nitrogen. They can provide a price signal that is sensitive to land use and intensity decisions and incentives to abate below consent levels.

### *Localisation of pricing*

70. Water pollution costs vary significantly by location. The marginal cost of emissions differs significantly across catchments, based on a range of geophysical variables and the level of current emissions. Pricing tools should also allow for local variation.

71. Locally variable pricing tools could take various forms. For example, catchment-level nitrogen discharge trading schemes have already been used in the Lake Taupo catchment, and are planned for the Rotorua Lakes; an alternative might be a national tax levied on estimated emissions, with catchment-level variation in rates.

72. Locally variable pricing tools could involve significant administrative and compliance complexity. An alternative approach is nationally uniform charging – for example, a fertiliser tax. Revenue raised from a nationally uniform charge or a nationally administered pricing tool could still be regionally allocated.

73. Setting the price may require challenging value judgements about the desired level of water quality. This is a key function of the National Policy Statement on Freshwater Management. Swimmability, drinkability, ecosystem health and aesthetic amenity considerations point to a range of possible standards. There may also be challenges in valuing and accounting for lost fauna, flora and ecosystems.

74. As with other environmental resources, it may not be possible to reflect the full cost of water pollution in the price but this shouldn't preclude the use of tax instruments in pursuit of positive environmental and ecological outcomes.<sup>17</sup>

### *Revenue potential*

75. The Group has not found comprehensive estimates of the revenue that could be generated by water pollutant taxes in New Zealand. To give a sense of the potential magnitude, the Group estimates that a \$2/kg charge on leached nitrates could raise approximately \$270 million per annum at current leaching rates and assuming 100% coverage.

### *Assessment*

76. If Māori rights and interests can be addressed, there could be a role for making greater use of tax instruments to address water quality with current tools, especially for nitrogen, and especially for regions struggling with excessive discharges. Even tax instruments using simple estimation approaches are likely to be preferable to having no tax instruments.

77. Water pollutant tax rates should ideally be sensitive to local catchment conditions (e.g. through local trading markets or locally differentiated rates). Pricing frameworks and systems should be developed, potentially at a national level for local application, to reflect this.

78. The Group encourages the further development of tools to estimate (and ultimately directly measure) diffuse water pollution, which would enable more accurate and effective water pollutant tax instruments. There is also a need to strengthen capabilities and capacities to develop and apply modelling tools, as well as verify compliance.

79. If significant progress is not made in the near term on implementing output-based tax instruments or other regulatory measures, the Group recommends the introduction of input-based tax instruments, including on fertiliser.

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<sup>17</sup> Costing externalities is important for the design of both tax instruments and regulation – both require policymakers to balance costs and benefits.

80. Regulation, education and support will therefore likely need to continue to play an important role in complementing potential tax instruments.

## Water abstraction

### *Objectives of a water abstraction tax*

81. Water abstraction taxes have a broader set of potential objectives than some of the other environmental tax opportunities. They include:

- rationing the total water take (i.e. pricing externalities)
- improving the efficiency of water use within allowable water takes (i.e. ensuring that water is allocated to its highest value use, including ecological and social uses)
- taxing natural resource use (i.e. capturing resource rents)
- funding the restoration of degraded water bodies.

82. The Government has taken a regulatory approach to the first objective: minimum flows and maximum takes are set following processes outlined in the National Policy Statement for Freshwater Management. Water tax instruments can play a complementary role by supporting the other three objectives.

### *Evaluation against the framework*

83. Fresh water abstraction generally meets the criteria in the Group's framework. It is generally feasible to measure major water takes, price signals can incentivise significant changes in behaviour and there is potential for significant long-term revenue.

84. However, there are significant design considerations that would need to be addressed before advancing potential water tax instruments, including Māori rights and interests, pricing localisation concerns and equity issues.

### *Māori rights and interests*

85. Any potential water taxes will need to take account of Māori rights and interests in water. There are well established concerns about questions of access, as well as ownership. Māori have less access to water than other land owners. Analysis from the Ministry for Primary Industries (MPI) suggests that in drier regions of New Zealand, only 3% of good quality Māori-owned land is irrigated, compared to 27% of all good quality land. There is ongoing work to better address Māori rights and interest in water, including through the Waitangi Tribunal and discussions between the Crown and iwi/Māori.

### *Localisation of pricing*

86. Water allocation pressures vary significantly by time of year and catchment.<sup>18</sup> Tax instruments should be sensitive to both time and place to reflect differences in the scarcity and value of water for ecological, social, cultural and economic purposes.

87. Better pricing of water has the potential to encourage a broad range of efficiency measures by water users, as well as greater investment in water storage and transport infrastructure that enhances natural capital.

88. There are risks to having tradeable water rights in highly localised water markets – there may be a small number of participants making it difficult to ensure competitive processes. The administrative costs of tradeable water schemes would also need to be considered.

### *Equity and distributional impacts*

89. Equity and efficiency considerations suggest environmental and resource taxes should, by default, have broad coverage. Applying this to water abstraction, this means all exclusionary users of water should be in scope for potential water taxes, including agriculture, hydroelectric generators and urban users.<sup>19</sup>

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<sup>18</sup> The value of water will also be sensitive to the prices of the products produced using the water e.g. milk and electricity.

<sup>19</sup> Special consideration may be warranted for non-consumptive users of water, such as hydroelectric generation. Water may still have value after non-consumptive use, although its ecological and economic value may have been depleted.

90. There are equity challenges in any potential allocation of water rights. Some of the value of existing water consents is likely capitalised in land prices and hydroelectric generator share prices. These equity concerns will need to be balanced against the interests of those who cannot obtain water consents, as well as the expectations of a fair return to the public, Crown or Māori. Water bodies may themselves have rights and interests, as recognised in the granting of legal personhood to the Whanganui River.
91. The distributional impacts on households of a water tax will also need to be considered, both from the direct cost of water charges and the incidence of any water charges imposed on firms (e.g. agriculture and electricity providers). People cannot live without water and it will be important to ensure that households have affordable access to water.

### **Assessment**

92. Water abstraction is a particularly challenging policy area in New Zealand owing to a range of different interests in the resource. Water is an essential resource for life, for recreation and for commerce. Water policy also impacts Māori rights and interests.
93. If Māori rights and interests can be addressed, water tax instruments (including auctioned tradeable permits) could be useful tools for improving the efficiency of water use. They could also be a significant and sustainable source of revenue over the long term.

## **Solid waste**

### ***Evaluation against the framework***

94. Solid waste meets the criteria in the Group's framework for the application of an externality tax. Solid waste streams are generally measurable. There is a diverse range of waste-reduction opportunities, including greater resource recovery and recycling, and investment in product designs and circular systems. Overseas experience has shown that landfilling is responsive to price signals. Waste taxes also have the potential to raise significant revenue in the short-to-medium term.

95. New Zealand already taxes waste through the Waste Disposal Levy. The levy is set at a rate of \$10 per tonne. It only applies at landfills that accept household waste. The limited scope means the levy is only applied to 11% of landfills, covering approximately 30% of waste disposed to landfills. The levy currently raises about \$30 million per annum (MfE 2017).

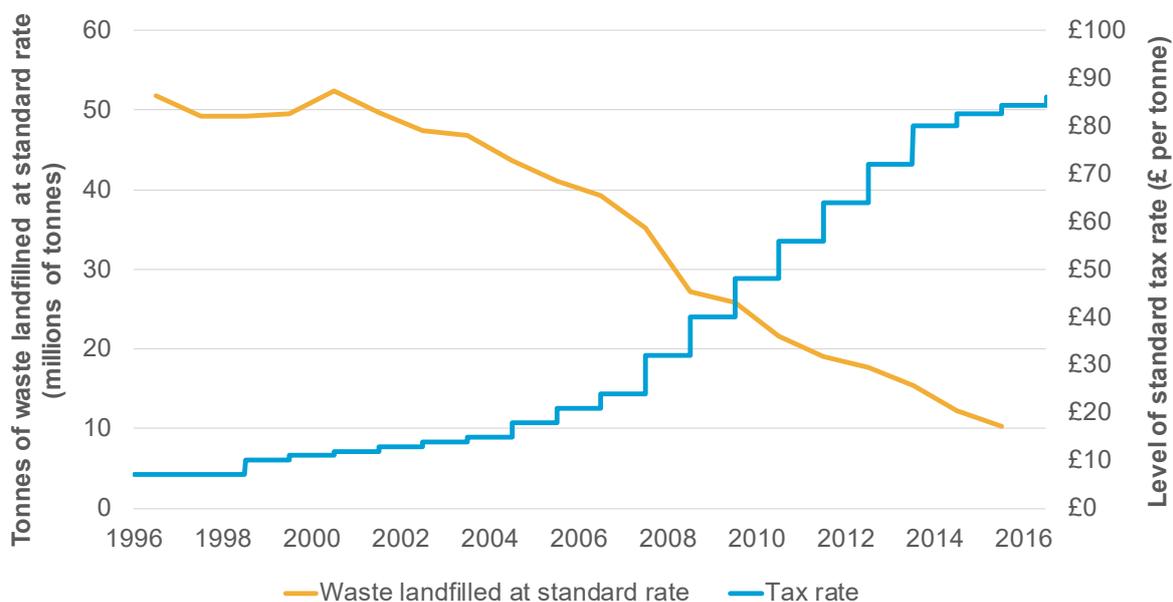
### ***Pricing***

96. Well-run landfill sites internalise many of the environmental costs in the disposal fees they charge. However, even well-run landfills generate externalities, such as leachates, air emissions (other than greenhouse gases covered by the ETS) and reduced amenity.
97. It is unclear whether the levy fully prices the externalities associated with waste and landfill disposal. Robust estimates of these externalities are challenging and depend on the site and waste product. A review in 2012 estimated that the costs of the environmental externalities – above the disposal costs of the landfill – ranged from \$1-\$19 per tonne (Covec, 2012). These estimates take a relatively narrow view of the externalities from waste, so it may be appropriate to look at a wider set of externalities, which could in turn justify a higher levy rate.

### ***Behavioural responsiveness***

98. A significant increase in the levy rate will likely change behaviour. The generation of waste is highly sensitive to price: overseas experience suggests that higher landfill taxes reduce waste production and increase recycling (Covec, 2012). As illustrated by figure 4.2, higher landfill taxes have driven extraordinary reductions in landfill volumes in the United Kingdom (although this has also been accompanied by increased incineration and waste exports).

Figure 4.2: Landfill tax rates and waste volumes in the United Kingdom



Source: HMRC

99. Increased efforts will be necessary to mitigate the risk that individuals resort to illegal dumping to avoid the levy. This could include refuse, reuse and recycling programmes, stronger penalties, education programmes and monitoring and enforcement measures.

**Fiscal potential**

100. The Waste Disposal Levy currently raises approximately \$30 million per annum.<sup>20</sup> A recent study by Eunomia, commissioned by the New Zealand Waste Levy Action Group, modelled revenue changes from increases in the levy to up to \$140/t for standard waste with a lower rate for inert waste (Eunomia, 2017). The modelling exercise found up to \$200 million in additional annual revenue from rate increases. The Group has not fully assessed modelling assumptions or approaches used in this analysis.

101. In the long run, the price elasticity of waste means that waste taxes may not be a sustainable tax base.

**Assessment**

102. The Ministry for the Environment is currently reviewing the rate and coverage of the Waste Disposal Levy. The Group supports this work. There is a case to expand the coverage of the Waste Disposal Levy beyond the 30% of waste currently covered, potentially with split rates to account for different external costs associated with different types of waste.

103. The Group recommends a reassessment of the negative externalities associated with waste and landfill disposal in New Zealand to ascertain if a higher levy rate would be appropriate. Higher rates should be introduced after an expansion of coverage to prevent leakage to unlevied landfills. Incineration levies may also be necessary to reduce waste generation.

104. The Group also supports revisiting the current approach to hypothecation, i.e. allocation of the Waste Disposal Levy, especially if there are significant increases in funds raised, to ensure they are being used in the most effective way to move towards a more circular economy.

<sup>20</sup> Approximately half of the funds raised goes to local councils and half is hypothecated to waste reduction projects through the Waste Minimisation Fund.

## Road transport

### *Evaluation against the framework*

105. Road transport generates a number of different negative externalities. These include road damage, congestion, greenhouse gas emissions, air pollution, noise, surface pollution, injuries and death. Some of these externalities better meet the criteria for negative externality taxes than others but there is generally a good fit.
106. A number of tax instruments already address some road transport externalities. For example, the ETS prices greenhouse gas emissions, and petrol and registration levies fund costs relating to injuries and death.

### *Measurement and pricing*

107. Congestion is likely to be the largest unpriced externality in road transport. Local air pollution, surface pollution and noise are also unpriced. These externalities are highly specific to time, place and type of vehicle. This has historically created measurement and pricing challenges.
108. There are now a range of technical solutions to make measuring and charging for these externalities feasible. For example, an enhanced road user charging system that captures information on location, time, type of vehicle and load could allow for more refined pricing of a broad range of externalities.

### *Equity*

109. Several submitters raised equity concerns with transport pricing, especially the impact of fuel taxes on low-income households. It is difficult to generalise about the impact of transport taxes. It will be important to assess the distributional impacts of specific proposals, and equity constraints could mean that pricing is used to signal some types of externalities, rather than accurately price them.

## Assessment

110. The Government and Auckland Council are currently considering whether or not to introduce congestion pricing in Auckland. The Government's Urban Growth Agenda is also scoped to review the future of the transport revenue system. The Group supports these reviews as an opportunity to better align road transport charges with externalities.

## Other pollutants and resources

111. New Zealand has royalty regimes for taxing minerals and petroleum mining. These royalty regimes were last reviewed in 2012 (MBIE, 2012).
112. The fiscal impact of any change to the petroleum and minerals royalty regimes will be relatively small. Royalties from petroleum and minerals mining were approximately \$200 million in 2017/18 or 0.2% of core Crown revenue.<sup>21</sup> In the absence of any new discoveries, royalties are forecast to decline in the coming years, reflecting declining petroleum production volumes and the decision not to grant further exploration permits for offshore petroleum mining. The Group does not recommend any changes to the royalty regimes. Any future reviews should take account of the Group's framework for taxing negative environmental externalities.
113. The Group acknowledges submitter concerns about the use of pesticides and suggestions for the introduction of a pesticide tax. The Group did not have sufficient information to assess whether tax was the most appropriate response to the underlying concerns. Regulation, including banning, may be more appropriate in some circumstances.

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21 Estimated revenues in FY2017-18 from petroleum, minerals, coal and ironsands royalties, as well as energy resource levies on coal and gas – <https://treasury.govt.nz/publications/ise/budget-2018-data-estimates-appropriations-2018-19>. The Government collects additional revenue from mining operations from corporate income tax.

## Distributional impacts and equity considerations

114. Environmental taxes can increase the cost of essential goods, such as energy, food and transport. Low-income households tend to spend a larger share of their income on these goods than higher-income households, so environmental taxes are often assumed to be regressive (Kosonen, 2012).
115. The actual incidence of environmental taxes will depend on a number of factors, including the consumption patterns of the taxed item, the availability of substitutes and the extent to which additional costs can be passed on to the final consumer. The distributional impact will also depend on the extent to which the revenue is recycled to help affected parties transition to more sustainable practices.
116. Environmental taxation can have a progressive impact if it successfully addresses the environmental issue, since lower income people can be disproportionately impacted by the degradation of the environment and ecosystem services.
117. The Group has not conducted a detailed assessment of the distributional impacts of the taxes in this chapter. However, the Group does not believe that potentially regressive impacts should rule out consideration of these taxes. Instead, the Government should be alert to distributional impacts and look to mitigate them as appropriate. Chapter 7 *Personal income tax* outlines a number of options for increasing the progressivity of income tax, which could also offset the distributional impacts of environmental taxation.
118. The Group recommends that the Government commission incidence studies to better understand who will incur the costs of new environmental taxes and to design appropriate mitigation measures.

119. The Group is also mindful of the particular impacts that environmental taxes can have on Māori and has included addressing Māori rights and interests as a key design principle for environmental tax instruments. Submissions to the Group by Māori organisations highlighted a range of viewpoints and concerns.

## Summary evaluation

120. Tables 4.2 and 4.3 summarise the performance of the five resources and pollutants against its negative externality framework.

## Tax concessions

### *Care of the land*

121. Several submitters suggested that costs associated with the care of land subject to QEII covenants should be treated as a deductible expense. The submitters argued that deductibility would support the purpose of the QEII covenant regime, as well as reduce compliance and administration costs. The Group agrees with this suggestion. The Group also recommends that privately incurred costs associated with the care of Ngā Whenua Rāhui should also be tax deductible.
122. Farming-specific deduction rules and depreciation rates should be reviewed as part of the Tax Policy Work Programme. This is to ensure they do not incentivise activities that destroy natural capital or disincentivise activities that enhance natural capital. This could involve both removing harmful concessionary provisions but also introducing positive incentives.

**Table 4.2: Evaluation of environmental tax opportunities in the short-to-medium term – criteria**

	Greenhouse gases	Water pollution*	Water abstraction**	Solid waste	Road transport***
<b>FAVOURABLE ATTRIBUTES</b>					
Behavioural responsiveness****	✓	✓	✓	✓	✓
Revenue-raising potential	✓	✓	✓	✓	✓
Diversity of response	✓	✓/✓	✓	✓	✓
<b>ESSENTIAL ATTRIBUTES</b>					
Measurability	✓	✓/✓	✓	✓	✓
Risk tolerance	✓	✓	✓	✓	✓
Sufficient scale	✓	✓	✓	✓	✓

✓ Largely met/high

✓ Partially met/medium

– Not met/low

\* Overall assessment of key water pollutants (nitrates, phosphates, sediment and pathogens).

\*\* Water abstraction taxes might be considered for taxing natural resource use, rather than pricing negative externalities, which could make some of the above criteria redundant.

\*\*\* Overall assessment of key unpriced road externalities, including congestion.

\*\*\*\* Assessment of short-term behavioural responsiveness. May be greater over the medium-to-long term.

**Table 4.3: Evaluation of environmental tax opportunities in the short-to-medium term – principles**

	Greenhouse gases	Water pollution	Water abstraction	Solid waste	Road transport
<b>DESIGN PRINCIPLES</b>					
Māori rights and interests	!	!	!		
Distributional/equity impacts	!	!	!	!	!
Externality cost pricing	!	!	!	!	
Localisation of pricing		!	!		
International linkages	!				
Integration with other policy		!	!		!
Intertemporal fairness	!	!	!	!	

! Priority issue

123. The forestry tax regime should also be reviewed to ensure it is delivering positive environmental and ecological outcomes in the most cost-effective way for the Government and does not disincentivise activities that enhance natural capital over the longer term (such as growing native trees for carbon storage).

### ***Petroleum mining***

124. The Group notes concerns raised by submitters around tax provisions for petroleum mining. The Group has not been able to assess these concerns in detail and recommends they be reviewed by officials as part of the Tax Policy Work Programme.

### ***Car parking and public transport***

125. The Group has also considered the treatment of car parks and public transport. At the moment, the provision of free car parking to employees is not subject to fringe benefit tax in many instances. Yet any contributions made to an employee's public transport costs *are* taxed. This treatment has the perverse effect of discouraging the use of public transport.

126. The Group acknowledges the practical difficulties involved in applying fringe benefit tax to employee car parks. In recognition of this constraint, the Group suggests the Government consider allowing employers to subsidise public transport use by employees without incurring fringe benefit tax.

## **The medium term – revenue recycling**

127. There is a strong case to recycle some or all of the revenue from environmental taxation into measures that support the transition to a more sustainable economy. This could help support those impacted transition to activities or land use that have a more positive impact on natural capital. For example, revenue could be recycled to help a farm with high emissions and high resource use in an ecologically sensitive area transition to a lower-impact operation.

128. Recycling environmental tax revenue has several benefits. It can reinforce the purpose of the tax by funding complementary activities (just as the Waste Disposal Levy is used to fund waste minimisation projects). It can address equity concerns arising from the incidence of the tax. It also enhances transparency, demonstrating that the tax is being introduced for environmental reasons and not to raise money for general government expenditure.

## **Longer-term possibilities – an extension of the tax base**

129. Over the longer term, environmental taxes could play a significantly greater role in the tax system and become a much more significant tax base. Innovative new tools could broaden the scope of negative externalities that can be measured, valued and taxed.

130. Greater tax revenue could also come from an expanded use of taxes on renewable and non-renewable resource use. A new approach to resource taxation, with a focus on intertemporal fairness, can ensure resources are used in a way that is fair to future generations of people and other species.

131. There are significant environmental challenges in New Zealand that are less well suited to environmental taxes. These tend to be environmental problems, where specific activities driving environmental change are more challenging to measure, such as biodiversity loss and impacts on ecosystem services.

132. The Group received several submissions highlighting new approaches that could be developed to address some of these challenges. An environmental footprint tax, for example, is a form of land tax set according to the intensity of land use and consequent impact on the environment. This has informed the Group's thinking on a natural capital enhancement tax. Biodiversity tax credits should also be considered.

### A natural capital enhancement tax

A natural capital enhancement tax is based on the idea of an environmental footprint tax and operates as a modified form of land tax. The tax is levied per unit area of land or privately owned coastal area. However, the rate of the tax is set to reflect the ecological impact of activities occurring on that land or coastal zone. Higher tax rates are applied to areas of land with low or degraded ecological value, for example, paved surfaces. Lower or even negative tax rates are applied to areas of land with high ecological value, for example, native forest or wetland.

The tax aims to recognise that natural capital produces valuable ecosystem services. It provides incentives for the conservation, restoration and regeneration of high-value natural capital, going beyond more narrowly targeted negative externality taxes. Remote sensing technologies, combined with mapping and modelling tools, could potentially be used to assess both the level and change in the ecological value of a specific area of land or coastal zone.

133. Discussions with submitters indicate that further work is needed to validate approaches like this, calibrate prices with externalities, and work through integration with other environmental taxes. Nonetheless, a natural capital enhancement tax is one example of the potential for new environmental tax instruments in the longer term.

## Summary assessment

134. The tax system can play a greater role in delivering positive environmental and ecological outcomes in New Zealand. It can help change behaviours and fund transitions towards a more regenerative, circular economy.
135. Environmental taxes should be considered together with other policy options, such as regulation and education, for achieving positive environmental and ecological outcomes. Our framework identifies a range of criteria and design principles for environmental taxes to be effective.

136. In the short term, there are opportunities to better use environmental taxes to price negative environmental externalities. Areas for improvement include the Waste Disposal Levy, the ETS and congestion charging. Further out, there could be benefits from greater use of tax instruments to address challenges in both water pollution and water abstraction.

137. The Group recommends reviewing a number of existing industry-specific tax provisions and the introduction of targeted new concessions to ensure the tax system is supporting and not harming natural capital.

138. The Group recommends the Government strengthen its capability to use tax for promoting positive environmental and ecological outcomes.

139. The Group recommends the Government commission incidence studies to better understand who will incur the costs of new environmental taxes and to design appropriate mitigation measures.

140. In the medium term, environmental tax revenue should be used to help fund a transition to a more sustainable, circular economy.

141. In the longer term, environmental taxes could extend New Zealand's tax base in a regenerative economy. This could be enabled by the consideration and design of innovative new tools like an environmental footprint tax or a natural capital enhancement tax.

142. This chapter identifies opportunities for using tax to achieve positive environmental and ecological outcomes. Further work is needed to rigorously assess how taxes can complement other environmental policy measures and to work through the design principles identified in this chapter.

# 5

## Extending the taxation of capital gains

1. Over the past year, the Group has assessed the structure, fairness and balance of the tax system. Through this work, the Group has come to the view that there are good grounds to consider an extension of capital gains taxation.
2. It is difficult, however, to make a recommendation about these matters in the abstract. This is because the extent to which the costs and benefits of extending the taxation of capital gains are realised in a New Zealand context will depend heavily on detailed design choices. It is therefore necessary to develop a concrete, worked-up set of options that can be assessed against each other.
3. In the *Interim Report*, the Group presented two broad options for dealing with these issues:
  - an extension of capital gains taxation (through the taxation of gains on assets that are not already taxed), and
  - the taxation of deemed returns from certain assets.
4. The Group's preferred option for detailed consideration is an extension of capital gains taxation. Since the publication of the *Interim Report*, the Group has fleshed out the design of a potential system for taxing capital gains. This chapter sets out the main features of that system, along with an assessment of its potential impacts.
5. It is worth emphasising at the outset that these are very much matters of judgement. None of the issues around capital gains are simple and reasonable people can disagree about the best way to deal with them.
6. On balance, the majority of the Group recommends a broad extension of capital gains taxation. Three members of the Group do not recommend this and prefer the incremental approach of carefully extending the tax base over time, which they consider has served New Zealand well over many years of tax reform. This chapter sets out the main issues considered by the Group in reaching these respective views.

### A system for taxing capital gains

7. This section briefly summarises the main features of a potential system for taxing capital gains. The Group has developed this system to allow for more detailed considerations of the advantages and disadvantages of extending capital gains taxation.
8. In broad terms, the system involves a realisation-based tax that is applied to gains on a broad range of assets. The gains would be taxed at full rates, with no discount and no allowance for inflation. Volume II provides a fuller description of the design features developed by the Group to underpin this system.

## What to tax

### *A broad coverage of assets*

9. The Group has taken a broad approach to the coverage of assets, to minimise differences in the tax treatment of different types of assets. The system would include gains from all types of land and improvements (except for the family home), as well as gains from shares, intangible property and business assets. The system would not include personal-use assets (such as cars, boats or other household durables).
10. The Group considers that some types of transactions relating to collectively owned Māori assets merit specific treatment in light of their distinct context. The Group recommends that the Government engages further with Māori to determine the most appropriate treatment of these types of transactions.
11. The system would use a defined list of 'included assets' to avoid the difficulties experienced by other countries, where unintended gains or losses have been brought into the tax base as a result of extending tax to all capital gains.

### *Gains after 'Valuation Day'*

12. The system would only tax the gains and losses that arise after the implementation date (referred to subsequently as 'Valuation Day'). This approach would require taxpayers to establish a market price for each included asset as at Valuation Day. This market price would represent the new 'cost base' against which future gains and losses would be measured.
13. The Group is not proposing that all assets need to be valued by valuers on Valuation Day, as this would impose an unmanageable burden on valuers. Instead, taxpayers should have five years from Valuation Day (or to the time

of sale if that is earlier) to determine a value for their included assets as at Valuation Day. If no valuation is determined, then a default rule should apply. This is considered in further detail in Chapter 5 *Transitional rules* of Volume II.

14. There are strong reasons to adopt a Valuation Day approach, since it would bring all assets into the tax base as soon as possible. The alternative approach – limiting the application of the tax to assets acquired after the date of introduction – would magnify lock-in effects, reduce the revenue raised by the tax and create an unfair distinction between people who bought assets before and after the introduction of the tax.<sup>22</sup> It might also require complex assessments to determine whether any changes to non-included assets would make those assets subject to the tax.
15. The Group acknowledges that there are differences in the ease of valuation, depending on the type of asset.
16. For land and improvements, the valuation options could include rating valuations or comparisons with other properties (for example, using a commonly available algorithm, such as QV valuation). Alternative valuation approaches could be used for other types of assets that are more difficult to value, such as the straight-line apportionment method.<sup>23</sup>
17. The Group encourages the Government and Inland Revenue to develop tools and guidance to further assist taxpayers through the Valuation Day process. In accordance with good administrative practice, the valuation process would need to strike a balance between achieving accurate valuations and imposing reasonable compliance costs on taxpayers. Taxpayers should also have the right to obtain a professional valuation and lodge it with Inland Revenue if that is a cost they are willing to bear.

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<sup>22</sup> Lock-in describes a situation where an investor is unwilling or unable to dispose of an asset because of the tax liability that will crystallise when the asset is disposed of. The investor is thus locked into ownership of the asset, even if they would otherwise prefer to sell and another owner could make more productive use of the asset.

<sup>23</sup> Under straight-line apportionment, an asset owner would determine the total gain on sale that had been made since they acquired the asset and then use a pro rata rule to assign a portion of that gain to the period after Valuation Day.

## When to tax

### *A realisation-based tax*

18. The tax would be imposed on a realisation basis in most cases. Imposing tax on realisation would ensure that the amount of the gain had been finally determined and – at least in most cases – that the person subject to the tax had the funds to pay it. Realisation is also the basis on which revenue account property is taxed under the current rules. Volume II provides examples of the situations that would count as ‘realisation events’.
19. The existing rules would continue to apply to foreign shares that are currently taxed under the fair dividend rate (FDR) method of taxation, as well as anything taxed under the financial arrangement rules.

### *Rollover treatment in certain circumstances*

20. Rollover treatment provides a deferral from taxation in certain situations. Rollover treatment does not mean that a gain or loss is never taxed. Instead, taxation is deferred until a later realisation event occurs that does not qualify for rollover. Rollover relief is a feature of all regimes involving capital gains taxation but the extent of relief varies markedly across jurisdictions.
21. Rollover relief can mitigate the distortionary impacts or perceived unfairness of a realisation-based tax. Yet rollover treatment reduces the revenue potential of the tax and is a source of much of the complexity in capital gains taxes in other countries.
22. The Group considers that decisions on rollover should be guided by two broad principles:
  - A case for rollover treatment may arise when there is a realisation but no change in the substance of ownership. One example of this is a transfer of relationship property, where the change in legal ownership merely reflects the fact that the recipient partner always had an equivalent interest in the property.

- A case for rollover treatment may also arise when there is a legal change in ownership but the transaction does not create a gain that has ‘come home’ to the vendor. One example of this is a case where land is compulsorily acquired for public works and the landowner uses the proceeds to acquire other land as a replacement. This situation can be contrasted with a voluntary sale to an unrelated party, where the vendor has willingly converted gains on certain assets into funds to use at their discretion (including for consumption) – in which case a clear gain has ‘come home’.

23. Volume II outlines the Group’s full recommendations on rollover treatment. Rollover treatment is predominantly limited to certain life events (such as death and relationship separations), business reorganisations and small business reinvestment.

## How to tax

### *Consistent treatment with other forms of income*

24. The Group has applied a principle that, as a form of economic income, capital gains should be taxed within the current income tax system. This means that any gains would be taxed at a person’s marginal tax rate. There would be no discount for capital gains and, consistent with the approach taken elsewhere in the tax system, there would be no adjustment for inflation.
25. The Group acknowledges that some submitters called for the application of reduced rates to gains. Reduced rates would increase complexity and compliance costs. Reduced rates would also limit the extent to which the tax improves the horizontal and vertical equity of the tax system. In any case, relative to an accruals-based tax, a realisation-based tax would already confer a significant deferral advantage on asset owners, which would offset the impact of inflation. There is not an obvious case to provide further favourable treatment beyond that.

26. The Group considered whether any adjustment is needed to address the 'bunching effect', where taxpayers are pushed into higher tax brackets as a result of realising a capital gain. The Group has decided that no adjustment should be made to compensate for this effect. Compared with other countries, New Zealand has a relatively flat tax scale, with the highest tax rate applying where a person earns more than \$70,000. Therefore, the Group does not consider that an adjustment is necessary.
27. In addition, there is likely to be no need for special rules for applying provisional tax to a capital gain earned during an income year. Taxpayers can manage volatility in their taxable income caused by capital gains and losses through existing options, such as tax pooling or the use of the different provisional tax calculation methods.
28. Expenditure incurred in acquiring an asset would be deductible at time of sale and costs incurred on improvements would be deductible from sale proceeds. Current law would be used to identify the costs of acquiring or improving an asset.
31. Rollover treatment, particularly for realisation events within a taxpayer's control, creates opportunities for taxpayers to 'cherry pick' by deferring gains and realising losses. Loss ring-fencing rules reduce this risk by only allowing losses from the sale of an asset to be offset against gains from the same or similar asset class. Therefore, the greater the extent of rollover treatment, the more loss ring-fencing is required.
32. In light of these considerations, the Group recommends that ring-fencing apply to portfolio investments in listed shares (other than when they are trading stock) and associated party transactions.
33. There is also a transitional issue associated with assets that enter the tax base on Valuation Day. As only gains and losses after Valuation Day would be taxed, the cost base of these assets would be set by a valuation rather than an arm's-length market price. To ease compliance costs on taxpayers, the Group has proposed that taxpayers should be able to choose from a variety of different valuation options. Some taxpayers might choose the highest valuation possible and not necessarily the most reliable.

### *Treatment of losses*

29. If capital gains are taxed in the same way as any other income, then capital losses should be treated in the same way as other tax losses. Taxpayers would generally be able to offset losses arising from the disposal of capital assets against ordinary taxable income (and not just against capital gains).
30. The ability to deduct capital losses from ordinary taxable income comes with some risks and would require careful monitoring by the Government. The Group is also concerned about integrity risks in certain situations where taxpayers have greater scope to bring forward losses and defer or exempt the tax on their gains.
34. The Group therefore recommends that losses from Valuation Day assets be ring-fenced against gains from other capital assets. The implication of this is that there would be extensive ring-fencing for some time. Assets purchased from a third party after Valuation Day would not generally be ring-fenced.

### *Other matters*

35. Volume II sets out further details of the system, including the treatment of KiwiSaver and other investment funds, tax on international investment and issues associated with taxing gains in companies.

## The deemed return method

36. While the deemed return method is not the Group's preferred method for dealing with the issue of capital gains, the Group has considered further how such a tax might be designed. This section sketches out the key features of the deemed return method.

### Key features

37. The Group considers that if the deemed return method were to apply then the asset best suited to the method is residential rental investment property. The deemed return tax would replace existing taxation on any rental income and would involve a simple calculation to determine the investor's tax obligations:

$$\text{Equity value at the beginning of year} \times \text{Deemed rate of return} \times \text{Investor's tax rate}$$

#### Example: Residential rental investment property

Tina owns a residential rental investment property worth \$1,000,000 at the beginning of the income year. The property is funded with \$300,000 of debt, implying equity of \$700,000. Tina is on the top marginal tax rate. The deemed rate of return is 3.5%.

Tina would owe tax for the year of \$8,085 (i.e. \$700,000 x 3.5% x 33%).

There would be no tax on any rent Tina earns from that property.

### Treatment of second homes

38. The deemed return tax would not apply to second homes that are rented out for some parts of the year. For second homes, any rental income arising from the home would be taxed under existing income tax rules but there would be no deductions for any expenses. Any capital gains on second homes would be taxed on realisation.

39. There would be boundary questions about whether a property is a rental property or a second house but there are boundary questions throughout the tax system and these can be resolved.

### Treatment of speculative gains

40. Deemed return taxation would work well for most rental properties but some mechanism like the bright-line rule may be needed to tax speculative short-term realised gains. In that case, any deemed return tax paid up until that point could be credited against the tax on realised gains.

### Revenue impacts

41. Using illustrative rates for the deemed return of 1.7% and 3.5%, projections by the Secretariat for the Tax Working Group show a substantial increase in revenue from residential rental investment properties, relative to the status quo.

**Table 5.1: Additional revenue from deemed return taxation on residential rental investment properties**

(\$ million)	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31
3.5% rate	998	1,015	1,148	1,241	1,343	1,444	1,555	1,665	1,794	1,922
1.7% rate	148	105	188	230	263	304	354	394	443	501

Note: 1.7% is an illustrative rate for two-year Government bonds – a proxy for the risk-free rate. 3.5% is an illustrative rate for two-year bank deposits, which are also very low risk. Revenue estimates are relative to the status quo, which incorporates tax revenue from rental income, tax arising from the bright-line test and additional revenue from ring-fencing residential rental losses. Revenue estimates are preliminary and indicative.

## Policy insights

42. The substantial additional revenue projected from deemed return taxation (relative to the status quo) indicates that residential rental investment properties are significantly undertaxed.<sup>24</sup> This accords with recent experience, where total returns on residential rental investment properties (including capital gains) have been well above returns for tax purposes. The increase in forecast revenue reflects the fact that the current approach to taxing rental income does not come close to taxing the expected total income from residential rental investment properties when capital gains are included.
43. The Group's preferred option for detailed consideration is an extension of capital gains taxation. The following section outlines the Group's assessment of this option.

## A policy assessment of the system for taxing capital gains

44. In deciding whether to recommend an extension of capital gains taxation, the Group has needed to come to a broad overall judgement:

In broad terms, will the **fairness, integrity, revenue** and **efficiency benefits** from reform outweigh the **administrative complexity, compliance costs** and **efficiency costs** arising from the extension of capital gains taxation?

45. The following sections work through the potential impacts of the Group's preferred design for taxing capital gains and then set out the final judgements reached by the Group.

## Equity and fairness impacts

46. Equity and fairness concerns provide the strongest rationale for contemplating an extension of capital gains taxation. A broad

extension to taxing capital gains would improve the fairness of the tax system by reducing inconsistency in the treatment of income, no matter how it is earned. It would also increase the progressivity of the tax system.

47. In forming this overall judgement, however, the Group acknowledges that a number of new inconsistencies would arise from various aspects of the design (such as the exclusion of the family home, which was required by the Terms of Reference).

## Distributional impacts

48. The individual impact of extending capital gains taxation will depend on each person's specific circumstances and will vary over time. International experience indicates, however, that capital gains taxes are highly progressive and primarily affect the wealthiest members of society. Burman and White (2003) provide one summary of the international evidence:

*In Canada, 1 percent of returns accounted for 60 percent of capital gains in 1997. In the United States, the richest 0.4 percent of returns accounted for nearly 60 percent of capital gains in 1998. In the United Kingdom, less than 0.1 percent of returns accounted for 60 percent of reported capital gains in 1997-1998 and paid more than 75 percent of all capital gains taxes.*

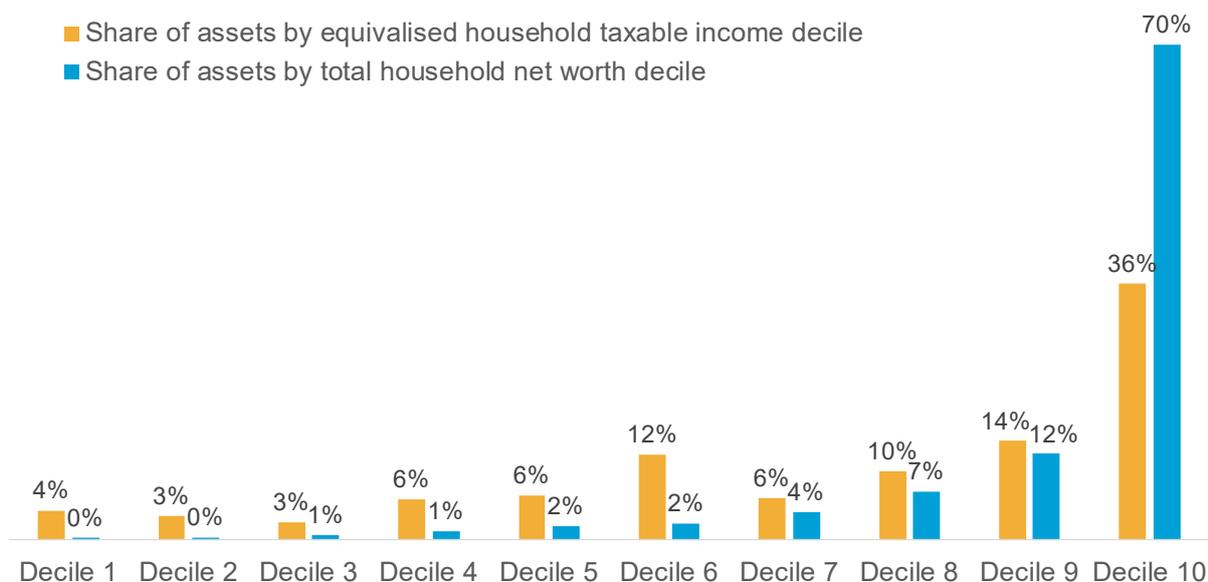
*Capital gains are an important source of income for the wealthy but much less so for the middle class. Over a ten-year period, capital gains accounted for almost 40 percent of the income of the richest 1 percent of taxpayers in the United States. By comparison, they made up only 5 percent of income for all non-elderly taxpayers and 14 percent of income for all those over age 64. A similar study in Canada found that, in 1987, capital gains averaged nearly 25 percent of income for the top 0.8 percent of taxpayers, compared with only about 1 percent for the bottom 75 percent.*

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<sup>24</sup> Revenue forecasts are over current projected revenue from residential rental income, tax arising from the bright-line test and additional revenue from ring-fencing residential rental losses.

49. In the absence of any capital gains data for New Zealand households, it is not possible to provide precise estimates of the distributional impact of extending capital gains taxation in New Zealand. However, one way of assessing the distributional impacts of capital gains taxation is to explore the ownership of the assets that would potentially be subject to the tax.
50. The ownership of these assets is skewed towards the wealthiest deciles. Figure 5.1 shows the distribution of household assets (excluding cash, deposits and owner-occupied housing) by household taxable income and household net worth deciles. 36% of these assets are owned by the top taxable income decile (using equivalised household income) while 70% of these assets are owned by the top net worth decile (using unequivalised total household net worth). This indicates the potential distributional impact of capital gains taxation (and is subject to the caveat that the data used to construct the income deciles does not include income from capital gains).
51. It is possible to derive a rough estimate of the distributional impact of extending capital gains taxation from the available data on household assets and the projected revenue from taxing capital gains. The total capital gains tax liability can be distributed between deciles based on their share of the assets that could attract capital gains taxation.
52. Extending the taxation of capital gains is likely to be highly progressive with respect to net worth deciles. Figure 5.2 below shows the potential distribution of the average annual capital gains tax payment, when expressed as a percentage of disposable income (excluding capital gains) by household net worth decile. This illustrative scenario suggests that, on average, households with higher net worth would pay a higher amount in tax as a percentage of disposable income than lower net-worth households.

Figure 5.1: Share of household assets that could be subject to capital gains taxation, by taxable income and net worth decile (2014/15)



Note: Data corresponds to figure 3.4.

Source: Stats NZ (Household Economic Survey 2015), the Treasury

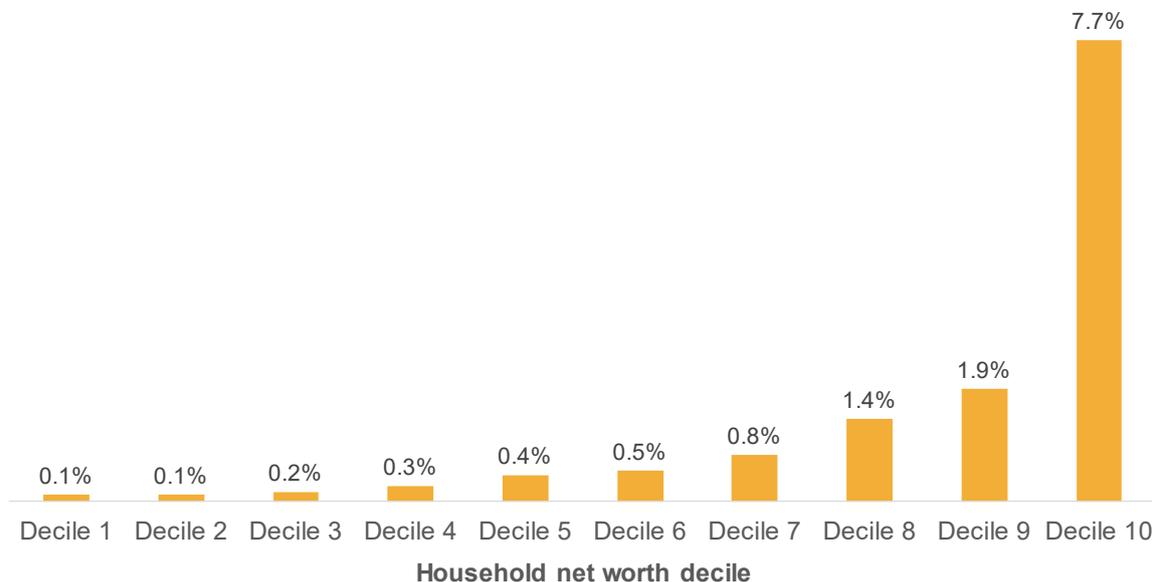
53. This analysis is limited by focusing on the legislative incidence of the policy. The actual distributional impact of extending the taxation of capital gains will depend on who bears the economic incidence of the tax and dynamic effects of the policy.
54. This analysis is also based on data from a single point in time and does not reflect the lifetime incidence of taxation. This is a significant limitation, because there is a strong age pattern to saving and hence to wealth.

### The housing market impacts of capital gains taxation

55. One key aspect of the economic incidence of the tax relates to its impact on the housing market. An assessment of these impacts is complicated by the fact that the tax would apply to residential property investments but not to owner-occupied housing.

56. Theory suggests that extending capital gains taxation would increase the ratio of rents to house prices owing to rents increasing, house prices falling or a combination of both. However, the supply of housing in New Zealand is very constrained. In a constrained market, where housing supply is unresponsive to changes in demand, theory suggests that extending capital gains taxation will have less of an impact on rents than would otherwise be the case and more of an effect in moderating prices.<sup>25</sup>
57. The Group has reviewed the results of two theoretical models to better understand the potential range of housing market impacts. These models both estimate an increase in rents relative to house prices – but generate inconsistent estimates for the effects on house prices.

Figure 5.2: Estimated annual average capital gains tax payment as percentage of disposable income, by net worth decile



Note: These estimates are based on the share of total household net worth that could be subject to capital gains taxation by household net worth decile (see figure 5.1) and projected revenue from the taxation of capital gains (see figure 5.3). Estimates for revenue from capital gains taxation are for the fifth year after introduction, discounted to 2021-22 tax year when the extension of capital gains tax is assumed to take effect. See Appendix A *Assumptions in projected revenue for extending the taxation of capital gains*. Estimates are preliminary and indicative.

Source: Stats NZ (Household Economic Survey 2015), the Treasury

<sup>25</sup> In a highly constrained housing market, landlords are likely to have significant pricing power and will already be pricing rents at what the market will bear. If landlords attempted to pass on the tax to tenants in higher rents, demand for rental property would be likely to fall: an increased number of tenants will find home ownership more affordable than renting.

58. There are some important caveats to this modelling. Models used in New Zealand tend to ignore (or provide a simplified treatment of) the impact of risk and uncertainty. The models reviewed by the Group assume that current tax parameters, interest rates, inflation and future returns on housing are all known and are certain to continue into the future. These are all strong assumptions.
59. In any case, empirical data suggests that other changes in the market are likely to swamp any effects from tax changes. The Group has explored the impacts of similar tax changes on housing markets in other countries (including Canada, Australia and South Africa). The Group has not observed significant increases in rents relative to prices in those countries – to the contrary, rents actually fell relative to prices. While there are only a small number of examples to observe, there is no evidence of a general rise in rents or a fall in prices following the implementation of capital gains taxes.
60. On balance, the Group expects that an extension of capital gains taxation would lead to some small upward pressure on rents and downward pressure on house prices. These impacts are likely to be small in relation to the impacts of more fundamental housing policy initiatives, such as the Government's KiwiBuild programme.

## Integrity impacts

61. Extending the taxation of capital gains would support the integrity of the tax system by reducing opportunities for tax planning and tax avoidance. In particular, it would reduce the incentive to classify assets on capital account in order to realise non-taxable gains. It should also ensure that income earned in companies – which is made available to shareholders for their personal use – is ultimately taxed at the personal tax rate. However, the Group recognises that another option for dealing with some of these issues in companies could be through the use of targeted anti-avoidance rules.

62. To ensure the effectiveness of an extension of capital gains taxation, there would be a need for new anti-avoidance rules to buttress the system, along with active monitoring and enforcement of avoidance activity by Inland Revenue.
63. The Group also notes that mandatory consolidation rules became necessary in Australia to ensure tax base integrity. The Government would need to consider equivalent rules in New Zealand. These rules would generate complexity and increase compliance costs.
64. Chapter 9 *Other opportunities to improve the tax system* outlines the Group's full set of recommendations to improve the integrity of the tax system.

## Revenue impacts

### Base broadening and fiscal sustainability

65. Extending capital gains taxation would broaden the tax base. It would also help to safeguard the Government's future revenue collection ability – particularly if the capital intensity of the economy increases as a result of technological change and/or demographic change. The additional revenue could be used to increase the Government's flexibility for dealing with future challenges or pay for other revenue-reducing reforms.

### Future flexibility

66. At present, the gap between the company rate and the top personal rate is small but there are still integrity problems with people using company structures and tax-free gains to lower their effective tax rates. This creates a strong imperative to maintain as much alignment as possible between the company rate and the top personal rate.

67. Extending capital gains taxation, on the other hand, would allow the tax system to sustain a larger divergence between the company rate and the top personal rate – giving future governments greater flexibility in their choices about the levels of company and personal income taxation (subject to consideration of any efficiency, compliance and administration costs).<sup>26</sup>

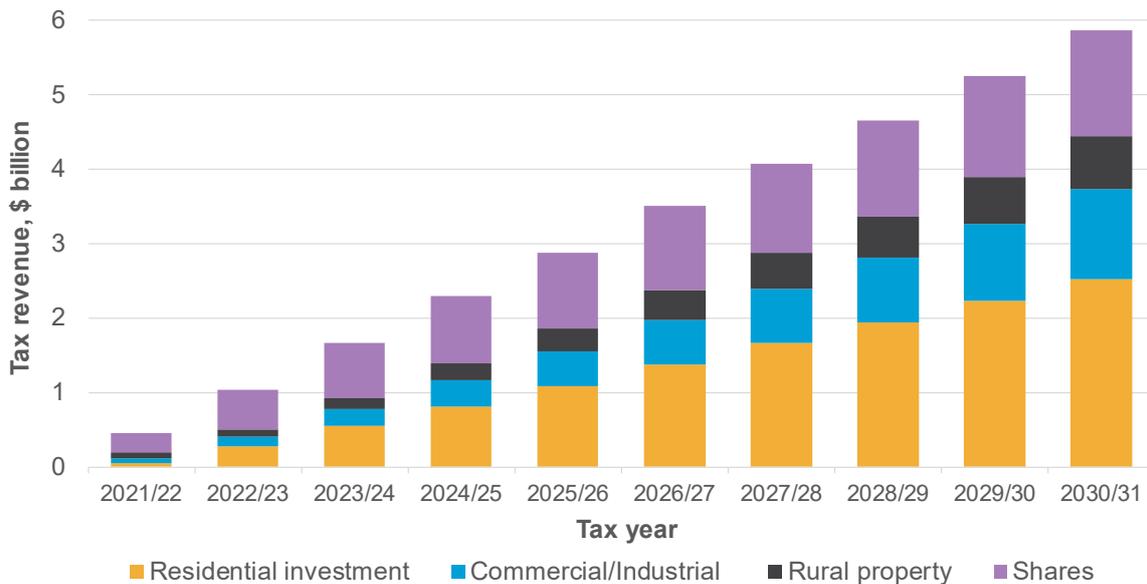
## Revenue estimates

68. The Secretariat for the Tax Working Group has modelled the revenue impact of extending the taxation of capital gains. These revenue projections are subject to considerable uncertainty because they depend heavily on assumptions (including future movements in asset prices). The assumptions underlying these projections are provided in Appendix A.

69. Revenue is projected to be small relative to GDP and total tax revenue. In the first ten years of implementation, an extension of capital gains taxation is projected to generate revenue of approximately 0.2% – 1.2% of GDP each year. Revenue should generally increase over time but the profile of the revenue will be volatile, because it will depend on movements in asset prices. The fiscal implications of this revenue volatility are discussed further below. Over the long term, revenue is projected to end up fluctuating around approximately 1.2% of GDP.

70. Extending capital gains taxation is projected to generate between 1% and 4% of total yearly tax revenue in the first ten years. Figure 5.4 illustrates the fiscal impact.

Figure 5.3: Projected revenue from an extension of capital gains taxation



Note: Assumes introduction in 2021/22 tax year. Shares include domestic listed shares held by managed funds and those not held by managed funds. Disposable income as defined here does not include income from capital gains. See Appendix A for further assumptions. Revenue estimates are preliminary and indicative.

Source: Secretariat for the Tax Working Group

<sup>26</sup> Currently, a shareholder earning income through a company can avoid paying the 'top up tax' (where they must pay the difference between the 28% company rate and their personal 30% or 33% rate) if a company does not distribute its income as a dividend, and a shareholder sells shares in that company for a capital gain.

**Table 5.2: Projected revenue from extending the taxation of capital gains**

(\$ billion)	2021/22	2022/23	2023/24	2024/25	2025/26	2026/27	2027/28	2028/29	2029/30	2030/31
Residential rental investment and second homes	0.05	0.28	0.55	0.81	1.09	1.38	1.66	1.94	2.23	2.52
Commercial, industrial and other property	0.07	0.13	0.23	0.35	0.47	0.60	0.73	0.88	1.04	1.21
Rural property	0.08	0.10	0.15	0.23	0.30	0.39	0.48	0.55	0.63	0.72
Domestic listed shares not held by managed funds	0.16	0.43	0.64	0.80	0.92	1.02	1.10	1.17	1.23	1.29
Domestic listed shares held by managed funds	0.09	0.09	0.09	0.10	0.10	0.11	0.11	0.12	0.13	0.13
<b>Total</b>	<b>0.4</b>	<b>1.0</b>	<b>1.7</b>	<b>2.3</b>	<b>2.9</b>	<b>3.5</b>	<b>4.1</b>	<b>4.7</b>	<b>5.3</b>	<b>5.9</b>
<b>% of GDP</b>	<b>0.1%</b>	<b>0.3%</b>	<b>0.4%</b>	<b>0.6%</b>	<b>0.7%</b>	<b>0.8%</b>	<b>0.9%</b>	<b>1.0%</b>	<b>1.1%</b>	<b>1.2%</b>
<b>% of total tax revenue</b>	<b>0.4%</b>	<b>1.0%</b>	<b>1.6%</b>	<b>2.1%</b>	<b>2.5%</b>	<b>2.9%</b>	<b>3.3%</b>	<b>3.6%</b>	<b>3.9%</b>	<b>4.2%</b>

Note: See Appendix A for further detail on revenue projection. Estimates are preliminary and indicative.

Source: Secretariat for the Tax Working Group

## Revenue volatility

71. The actual revenue from an extension of capital gains taxation is expected to be volatile because of its dependence on asset price movements. As figure 5.5 illustrates, the experience in Australia suggests that there can be significant peaks and troughs in capital gains revenue.<sup>27</sup>

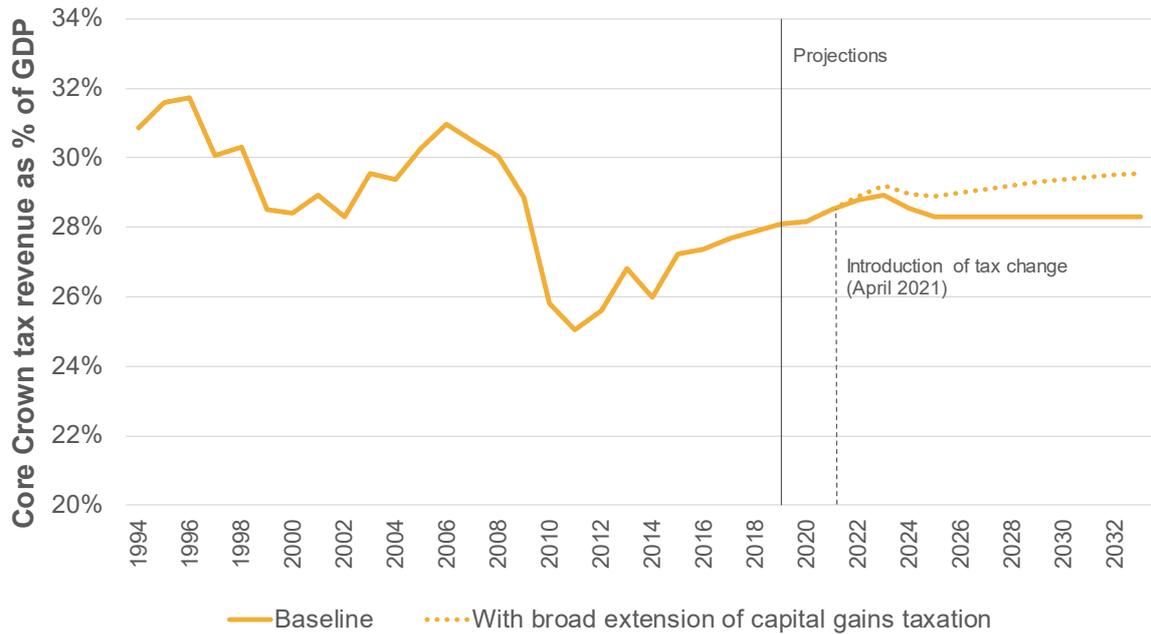
72. Revenue from the taxation of capital gains will tend to increase during economic upswings and decrease during economic downswings. This will occur ‘automatically’ as the level of tax revenue collected will depend on the size of capital gains, which tend to rise and fall with the economic cycle. Extending the taxation of capital gains would thus serve as an ‘automatic stabiliser.’ Automatic stabilisers dampen fluctuations in economic activity and smooth the edges of the business cycle by reducing the amount of tax that households pay when the economy is in a downswing (and increasing tax paid in an economic upswing).

73. There are benefits to New Zealand having automatic stabilisers, particularly if there continues to be less scope for monetary policy to act in such a role. However, the effectiveness of extending the taxation of capital gains as an automatic stabiliser is uncertain. The impact on dampening economic fluctuations will partly depend on how household spending responds to changes to the taxation of capital gains. The effect may be weak to the extent that the tax is mostly borne by high-income households, which have a lower propensity to alter their spending in response to marginal changes in net income.

74. Greater revenue volatility will also require disciplined fiscal management, so that future governments do not lock themselves into permanent spending commitments on the basis of temporary peaks in capital gains revenue.

<sup>27</sup> The revenue generated by the Australian capital gains tax was affected significantly by the policy decision to ‘grandparent’ assets owned at the time of the introduction of the tax.

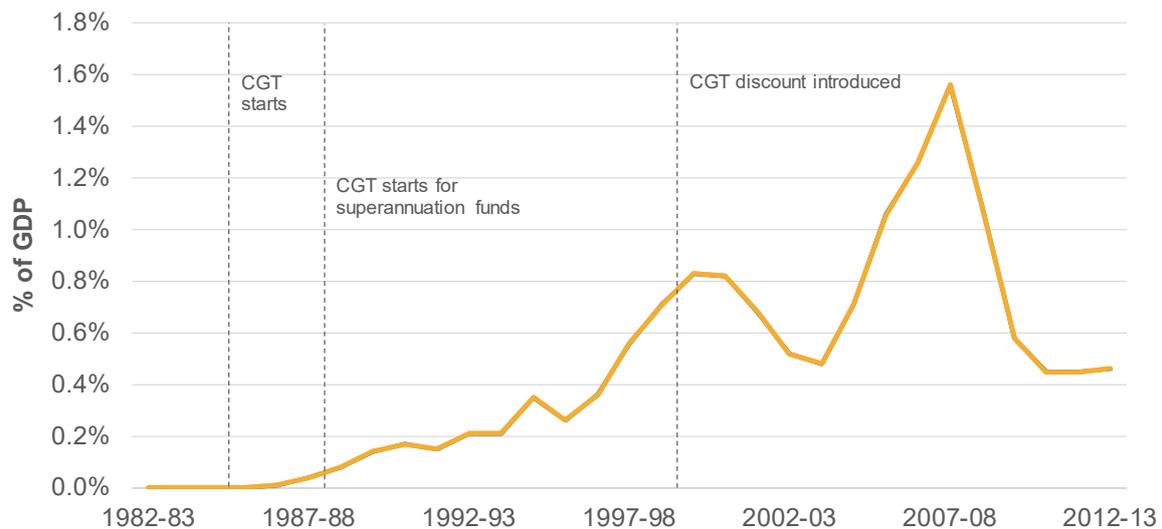
**Figure 5.4: Fiscal impact of extending the taxation of capital gains**



Note: The projection of revenue from extending the taxation of capital gains is preliminary and indicative. Baseline estimates and projections of core Crown tax revenue are from the Treasury’s Half Year Economic and Fiscal Update (HYEFU) 2018. From 2022/23, the fiscal projections assume that tax revenue is held constant as a share of GDP, i.e. the Government implements revenue-negative tax packages to offset fiscal drag. However, if the effects of fiscal drag are not offset, and no changes are made to capital gains taxation, tax revenue would continue to increase as a share of GDP throughout the projection period, reaching 29.5% of GDP in 2030/31.

Source: Secretariat for the Tax Working Group, the Treasury

**Figure 5.5: Australia revenue from the taxation of capital gains as a percentage of GDP**



Note: Capital gains tax became applicable to superannuation funds with the introduction of the 15% tax on earnings implemented from 1 July 1988.

Source: PBO based on data from the Australian Bureau of Statistics and the Australian Treasury

## Efficiency and productivity impacts

75. Extending the taxation of capital gains would have multiple impacts on productivity. Broadly, there are two competing influences:
- positive impacts arising from improvements to the allocation of investment across the economy, and
  - negative impacts arising from a higher level of capital taxation, an increase in compliance costs and the effect of lock-in on investment decisions.
76. It is difficult to estimate which of these influences would dominate. New Zealand has a known low productivity problem. However, international agencies – including the International Monetary Fund (IMF) and the OECD – have concluded that extending the taxation of capital gains would generate net benefits for New Zealand.
77. The following sections examine each of the productivity impacts in turn.

### The allocation of investment

78. There can be valid public policy reasons for the Government to influence investment decisions through the tax system. For example, Chapter 4 *Environmental and ecological outcomes* outlined a number of ways in which the tax system could be used positively to support a transition to a more sustainable pattern of economic activity.
79. In the absence of a broader public policy rationale, however, the tax system generally strives to achieve ‘neutrality’ in the treatment of different types of investments. A neutral tax system – which does not favour one type of investment over another – reduces the incentive for firms to make investments solely for tax reasons.

80. As discussed in Chapter 3 *The structure, fairness and balance of the tax system*, the current treatment of capital gains gives rise to a significant ‘non-neutrality’ in the tax system. This is because the inconsistent taxation of capital gains reduces the tax obligations of some sectors and industries relative to others.
81. The current treatment of capital gains may reduce productivity to the extent that it distorts investment into less productive – but tax-favoured – sectors and industries. A more comprehensive approach to taxing capital gains would enhance productivity by greatly reducing this distortion. The IMF (2017) finds that greater neutrality in the tax treatment of investment can ‘chip away’ at the problem of resource misallocation and enhance productivity across the economy.
82. The Group acknowledges that some aspects of the design – such as rollover treatment and loss ring-fencing – would generate new distortions.

### Higher capital taxation

83. An extension of capital gains taxation is, effectively, an increase in the taxation of savings and investment. In economic theory, this type of ‘capital taxation’ is generally expected to have a negative impact on levels of investment in the economy.
84. By itself, this effect may reduce productivity. Yet the additional taxation would generate a new stream of revenue. It is not possible to form a judgement about the overall impacts on productivity without considering how the additional revenue would be spent.
85. Most business investment takes place through companies. Extending the taxation of capital gains would influence company investment in two main ways: by taxing gains from the assets owned by companies and by taxing gains on shares in the company.

86. Additional taxes on investment at the company level could reduce business investment to the extent that a company's profits come from capital gains. The impact of taxing gains of its shareholders, however, would depend on the extent of the company's access to international capital markets.
- For New Zealand companies with significant foreign shareholdings, the cost of capital is largely influenced by the demands of foreign shareholders. Under current double taxation agreements with other countries, it is not generally possible to tax foreign shareholders on the gains from their shares.<sup>28</sup> An extension of capital gains taxation in New Zealand would thus have little effect on foreign shareholders and is unlikely to increase the cost of capital by very much for companies with substantial access to international capital markets.
  - Most small-to-medium enterprises, however, cannot readily access international capital markets. Instead, they depend on funding from domestic investors to make additional investments. Taxing domestic investors on the gains from their shares would increase the cost of equity capital for these types of companies and could reduce investment.
87. Complex rules would be required to counter double deductions in corporate groups. There is also a prospect of double taxation for shareholders. Double taxation would impose a tax penalty on New Zealanders owning shares in New Zealand companies relative to investment in foreign shares (which would continue to be taxed under the fair dividend rate method).
88. An extension of capital gains taxation would require a redesign of the rules that apply to KiwiSaver and portfolio investment entities (PIEs). The current rules offer a relatively consistent tax treatment of investors, irrespective of the entity through which investments are made. Any inconsistencies arising from the new rules risk damage to New Zealand's capital markets. The Group recommends further consultation to ensure that the final rules do not create a bias in favour of investment in foreign shares.

## Lock-in

89. Any realisation-based taxation of capital gains would create some degree of lock-in but the exact impacts are difficult to quantify. Lock-in may encourage some investors to take a longer-term perspective to their investment decisions but it could also deter others from investing into new classes of assets.
90. The extent of lock-in would be particularly influenced by design choices regarding rollover treatment. More generous rollover treatment would reduce lock-in in the short term but could increase lock-in in the long term, as untaxed gains accumulate in those assets. A greater use of rollover treatment would also increase compliance costs, increase distortions and reduce revenue.

## Compliance and administration costs

91. An extension of capital gains taxation would increase compliance and administration costs. For taxpayers, there would be two types of compliance costs: one-off costs associated with the introduction of the tax and ongoing compliance costs.

### *One-off compliance costs*

92. Major one-off compliance costs would arise as a consequence of taking a Valuation Day approach to the introduction of the tax. The Group has sought to reduce the compliance costs associated with Valuation Day in a number of ways – such as allowing taxpayers up to five years to obtain a valuation for their assets and encouraging Inland Revenue to develop low-cost and easy-to-access options to help taxpayers comply with their obligations.

### *Ongoing compliance costs*

93. The ongoing compliance costs would mostly relate to valuation, record-keeping and compliance with complicated rules (such as rules for rollover treatment or integrity rules to prevent double deductions).

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28 One exception is that gains in the value of shares in land-rich companies may sometimes be taxed.

94. Valuation issues would arise when certain assets are transferred between associated parties or when certain assets move in or out of the tax base. As with Valuation Day, the Group encourages Inland Revenue to develop low-cost options for valuation that are sufficiently robust to maintain the integrity of the tax system.
95. In terms of record-keeping, the Group recommends that information on the cost base of assets (including additions made that year to the cost base, as well as when an asset has been rolled over) be filed on a contemporaneous basis. This may increase short-term compliance costs but should also reduce the number of disputes when the asset is finally disposed of or sold.
96. Other costs may arise if the Government imposes information reporting requirements or withholding taxes. The Government should consult on whether there is a need for such requirements – and, if so, how widely to impose them.
101. According to Australian practitioners contacted by the Group, some of the key sources of compliance costs are valuation (particularly for intangible property or when a valuation is disputed by the Australian Taxation Office), record-keeping, rollover, small business concessions and other exceptions.
102. One example of this type of cost is the need for large corporates undergoing business reorganisation to obtain a ruling from the Australian Tax Office that the reorganisation qualifies for rollover treatment.
103. Many of the compliance costs arise from the rules that are necessary to buttress the integrity of the tax. These include the rules for preventing double deductions (outside of consolidated groups) and the qualifying criteria for small business concessions (which have been subject to frequent law changes).

### ***Compliance cost estimates***

97. There have been few studies of the overall compliance costs of capital gains taxes in other countries. The Group has reviewed studies on the compliance costs generated by capital gains taxes in Australia and the United Kingdom.
98. In Australia, the capital gains tax affects relatively few taxpayers each year, so it has lower annual average compliance costs for businesses compared to other types of taxes. However, the set of taxpayers that are affected by Australia's capital gains tax face high costs, and compliance costs are high relative to the revenue raised by the tax.
99. Tables 5.3 and 5.4 illustrate the average costs – in terms of both time and money – imposed on businesses by the Australian capital gains tax regime.
100. Although this research suggests that average compliance costs across the economy are small, anecdotal evidence from Australia indicates that taxpayers can face very high compliance costs at certain moments in time.
104. Extending capital gains taxation is likely to reduce the tax bias on investment decisions but the Group acknowledges that it would also generate an important set of efficiency costs. It may be possible to mitigate these costs by using some of the additional revenue to fund productivity-enhancing reform elsewhere in the tax system. Chapter 6 *The taxation of business and savings* outlines a range of options for boosting business productivity.

### **Overall impacts on efficiency and productivity**

### **A summary of the advantages and disadvantages**

105. The Group's analysis of capital gains taxation has covered a wide range of dimensions. Table 5.5 summarises the main advantages and disadvantages covered by the Group's analysis.

**Table 5.3: Average hours spent per year by small- and medium-sized businesses on tax compliance**

Size of business by turnover	Capital gains tax	Income tax (excluding capital gains tax)	GST	All taxes
Up to AU\$75,000	0.4	15.8	15.7	37.5
AU\$75,000 to \$2 million	2.6	35	66.6	143.6
AU\$2 million to \$50 million	12.4	55.4	148.5	482.2
Average for all businesses up to \$50 million of sales	4	33	69	185

Source: Evans, Lignier and Tran-Nam (2014)

**Table 5.4: Large corporations' total tax compliance costs (percent of total)**

Type of cost for large corporation	Capital gains tax	Income tax (excluding capital gains tax)	GST	Fringe benefit tax
External tax advisor costs (% of total cost)	2.1%	66.4%	9%	5.3%
Internal staff time spent on tax activities (% of total time)	2.6%	52.9%	15.9%	11.7%

Source: Evans, Lignier and Tran-Nam (2016)

**Table 5.5: The advantages and disadvantages of extending capital gains taxation**

Impacts	Advantages	Disadvantages
Revenue	<ul style="list-style-type: none"> <li>Enhances fiscal sustainability by broadening the tax base.</li> <li>Enhances flexibility of tax system by allowing for greater future divergence between company rate and top personal income rate.</li> <li>Source of revenue for additional public services and/or tax reform.</li> </ul>	<ul style="list-style-type: none"> <li>Volatile source of revenue.</li> </ul>
Equity and fairness	<ul style="list-style-type: none"> <li>Enhances horizontal equity: greater consistency in treatment of income, no matter how it is earned.</li> <li>Enhances vertical equity: increases the progressivity of the tax system.</li> </ul>	
Integrity	<ul style="list-style-type: none"> <li>Reduces opportunities for tax avoidance and evasion.</li> </ul>	
Efficiency and productivity	<ul style="list-style-type: none"> <li>Improves the allocation of investment by reducing the tax bias on investment decisions.</li> </ul>	<ul style="list-style-type: none"> <li>Higher capital taxation likely to discourage some savings and investment.</li> <li>Inefficiencies associated with lock-in.</li> </ul>
Compliance and administration		<ul style="list-style-type: none"> <li>Greater complexity leads to higher administration and compliance costs.</li> </ul>

## Summary assessment

106. Over the past year, the Group has built a good understanding of the rules needed to impose a system for taxing capital gains and the trade-offs involved. It is clear, though, that these are very much matters of judgement. None of the issues around capital gains are simple and reasonable people can disagree about the best way to deal with them.
107. All the members of the Group agree that there should be an extension of the taxation of capital gains from residential rental investment properties. This sector is undertaxed when only rental income is in the tax base. Moreover, rents are low relative to house prices (particularly in areas where land prices have been rapidly increasing). This suggests that investors have been investing with the expectation of capital gains, which are generally untaxed.
108. Eight members of the Group support the introduction of a broad approach for taxing capital gains, in accordance with the system outlined in this chapter and detailed in Volume II. In reaching this judgement, the majority accepts that extending capital gains taxation would involve an increase in compliance and efficiency costs but judges that these costs would be outweighed by reductions in investment biases, as well as improvements to the fairness, integrity and fiscal sustainability of the tax system. Moreover, some of these costs could be offset by other measures within a package of tax reform.
109. Three members of the Group have reached a different judgement. These members prefer the incremental approach of extending the tax base carefully over time, which they consider has served New Zealand well over many years of tax reform. In their judgement, the revenue benefits, perceptions of fairness and possible integrity benefits would be outweighed by adverse efficiency impacts, increased compliance and administration costs, and fiscal risk.

## Choices and options

110. The Government does not face a binary choice regarding whether or not to extend capital gains taxation. There is a spectrum of choices for the coverage of assets, and the inclusion of each asset class comes with its own costs and benefits.
111. At one end of the spectrum, there is a clear case to include residential rental investment properties (by taxing either the realised gains or deemed returns from those assets). In the middle of the spectrum, there are listed shares, land-based businesses and commercial property. At the other end of the spectrum, there is greater complexity regarding the treatment of corporate groups, unlisted shares and business goodwill.
112. For this reason, the Government could choose to extend the taxation of capital gains to some asset classes only. The Government also has options around how to stage the timing of introduction, whether to phase in the inclusion of asset classes, whether to grandparent some or all asset classes or whether to apply the deemed return method.
113. If the Government decides not to extend capital gains taxation to all asset classes, Inland Revenue must have sufficient resources and capability to fully enforce the existing capital/revenue boundary. This includes the taking of test cases (to ensure that revenue gains cannot be reclassified as capital gains) as well as policy and investigative attention to existing areas of concern.

## The importance of effective implementation

114. Regardless of their position on the merits of capital gains taxation, all members agree that the introduction of a system for taxing capital gains would be a significant endeavour requiring the full attention of the Government.
115. If the Government decides to proceed, it is crucial that Inland Revenue is fully resourced and has the capability to develop and implement the new tax. The policy and legislative processes must include thorough consultation with a diverse range of voices, using both formal and informal channels. It will be particularly important to identify further options for reducing the compliance costs of the new tax.
116. The Group also notes that the Government's stated timeframes for implementing tax reform will be challenging. The Government will need to ensure additional resources are available for implementation if these timeframes are to be achieved.
117. Nevertheless, while introducing a system for taxing capital gains is a significant task, it would also open up new opportunities for broader reform of the tax system or for investment into public services. The following chapters outline a range of options for tax reform that could be unlocked by the additional revenue.

# 6

## The taxation of business and savings

### The taxation of business

1. The Group discussed the taxation of business at some length in the *Interim Report*. In that report, the Group concluded that the current approach to the taxation of business is largely sound. The Group does not see a case to reduce the company rate or to move away from the imputation system. The tax rate for Māori authorities also remains appropriate (although the rate should be extended to the subsidiaries of Māori authorities).
2. The Group also considered in the *Interim Report* whether there is a case to introduce a progressive company tax (i.e. a lower company rate for small businesses). The Group found that progressive taxation is already possible through the use of look-through company structures. Beyond this, the Group judged that the efficiency costs and integrity risks associated with a progressive company tax would outweigh any benefits in terms of faster small-business growth.
3. However, the Group has identified a number of areas where tax reform could support the productive economy, boost investment and reduce compliance costs.

### Supporting the productive economy

4. The Group has considered two measures that could help to boost the productive sector of the economy: changes to the loss-continuity rules and changes to the treatment of 'black-hole' expenditure.

### Loss-continuity rules

5. Losses and income are treated asymmetrically under New Zealand's company tax system. Companies pay tax when their income is positive but the Government does not provide a refund when income is negative. Instead, losses can be carried forward to offset any tax obligations associated with the future income of the company.<sup>29</sup>
6. The loss-continuity rules determine whether losses from a previous year can be used in a future year. Generally, losses may be used to offset future income, unless more than 51% of the company's shares have changed hands since the losses were incurred.
7. The loss-continuity rules require a balance between efficiency and integrity objectives. Strict rules can reduce efficiency by discouraging risk taking but loose rules may allow companies to reduce their taxable income by trading in losses.
8. The Group considers the existing loss-continuity rules are appropriate for most companies but may not be working well for start-up firms. These firms require equity capital to grow. The capital is often raised over time, through multiple rounds, from differing types of investors. Yet these firms are often inherently loss-making as they grow from an idea to a viable business. The existing loss-continuity rules may be constraining their ability to grow through additional equity capital.

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<sup>29</sup> Alternatively, the losses can be used to offset the taxable income of other 'commonly owned' companies (i.e. companies in which at least 66% of shareholders are the same as in another company).

9. The Group recommends changes to the loss-continuity rules that would support the growth of innovative start-up firms. Any relaxation of the rules would need to be carefully calibrated to ensure that the change does not facilitate trading in losses among larger firms. The Group does not recommend an extension of loss-continuity rules from one based on shareholding to one based upon a 'same or similar' business test, as is the case in Australia.

### ***Black-hole expenditure***

10. Black-hole expenditure is business expenditure of a capital nature that is not immediately deductible for tax purposes and does not give rise to a depreciable asset and therefore deductible over time. An example of black-hole expenditure arises when a business incurs costs to try and develop an investment in a new asset, process or business model.

- If the expenditure results in the acquisition or development of a new asset, the expenditure can be capitalised and depreciated over time.
- If, on the other hand, the firm decides along the way *not* to proceed with the project and no asset is acquired or developed, then the expenditure incurred up to that point may not be deductible and the expenditure is said to have fallen into a 'black hole'.

11. The current treatment of black-hole expenditure could mean that firms are less likely to take risks on new assets, processes or business models unless they are reasonably certain that the investment will pay off. It therefore discourages the risk taking and innovation that drive productivity growth.

12. The Group therefore recommends that the Government reform the treatment of black-hole expenditure. This would involve:

- A new rule to recognise deductions for expenditure that is incurred by businesses and not otherwise dealt with under the Income Tax Act. This rule would also apply if an asset is abandoned, either fully or partially, before its completion.
- Where an abandoned asset or project is subsequently restored, any corresponding tax deductions would be clawed back and the taxpayer would capitalise the value of those deductions. The capitalised value of the asset would be deductible via the tax depreciation rules in the Income Tax Act.
- Expenditure would be spread over five years.

13. To reduce compliance costs – particularly for small businesses – there would be a safe-harbour threshold of \$10,000 to allow upfront deductions for low levels of feasibility expenditure.

14. In the Group's view, a decision to extend the taxation of capital gains would only strengthen the case to deduct black-hole expenditure. If income is to be taxed on a more comprehensive basis, then it will generally be appropriate to allow a broader range of deductions.

### ***Goodwill***

15. The cost of acquiring goodwill is not currently deductible. If goodwill becomes taxable at sale under the proposed extension to the taxation of capital gains, or under future targeted tax reforms, then the appropriate timing and quantification of deductions for expenditure on goodwill needs to be determined.

## Boosting investment

16. One of New Zealand's long-running economic challenges is its low rate of capital investment. The Group has considered a number of ways in which the tax system affects investment, as well as options for supporting investment in nationally significant infrastructure.

### *Building depreciation deductions*

17. New Zealand abolished depreciation deductions for buildings in 2010, with effect from the 2011-12 tax year. Data at the time suggested that over a particular time period, the value of some types of building capital had appreciated (even though building structures themselves deteriorate over time). The change was also introduced as part of a package that included a reduction in the company tax rate.
18. The result of this change is that the tax system may now discourage efficient investment in new improvements. This is because there are very high effective tax rates on new building activity in New Zealand. As shown in figure 6.1, New Zealand had the highest effective tax rate for foreign investment into both manufacturing plants and office buildings among OECD countries in 2015 (Hanappi, 2017).<sup>30</sup> Reintroducing building depreciation at illustrative rates of 1% or 2% would move New Zealand closer to the OECD average.
19. The absence of building depreciation deductions does not affect all industries equally. Some industries have a greater reliance on buildings

for their output, and so the abolition of building depreciation deductions has disadvantaged some industries relative to others.

20. Figure 6.2 outlines the relative disadvantage faced by some industries by comparing the value of the non-residential building stock in that industry to a measure of business profits (Gross Operating Surplus). Figure 6.2 shows, for instance, that retail and agriculture are impacted much more than mining or business services.

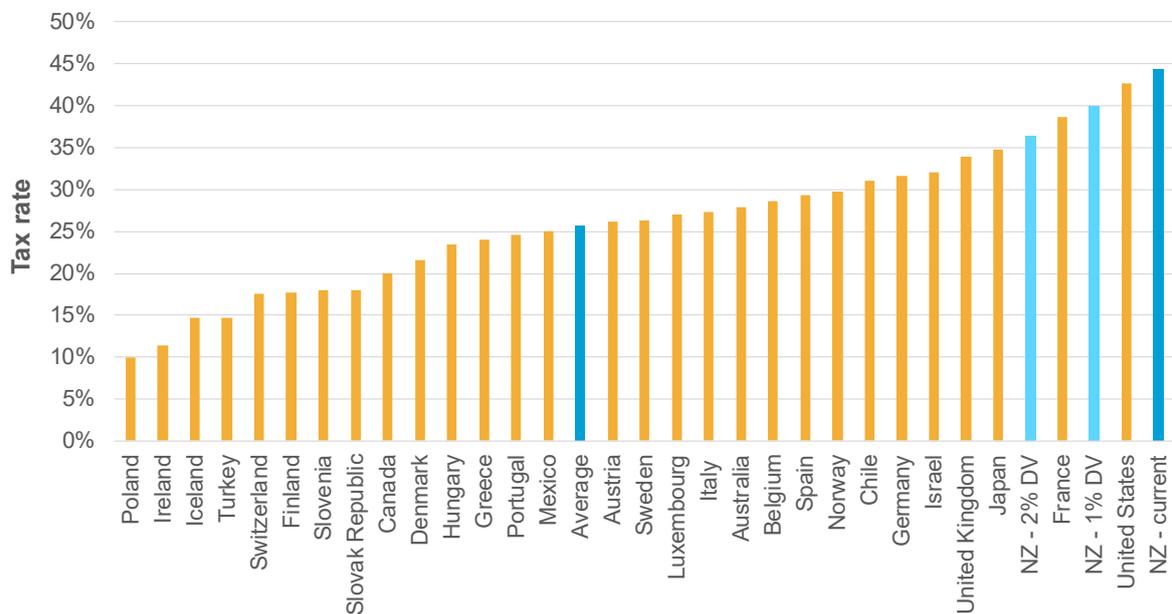
### *The appropriate rate of depreciation*

21. International evidence suggests that large buildings typically depreciate at a rate of 2%-4% per annum (Bureau of Economic Analysis, 2003). However, there are reasons to consider a lower rate. The first is fiscal cost. The second is that inflation will increase the nominal value of sold buildings and end up having a larger effect on longer-lived assets than shorter-lived assets. Further, if more capital gains become taxed, owners may claim tax losses on sale if the depreciation rate is set too low. On balance, a rate of 1% might be appropriate.
22. The Group also notes that the imperative to set the 'correct' rate of depreciation will lessen with the taxation of the capital gains, because any difference between tax depreciation and economic depreciation will be reversed on realisation. Losses on sale will become deductible. The only cost or benefit that will arise will be based on the timing of receipt of the allowance for depreciation.

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<sup>30</sup> The effect for domestic investors is muted by the role of imputation. Furthermore, these figures only partially capture the effect of the taxation of capital gains in other countries, as although it includes a capital gains tax, it does not assume any real appreciation in the value of the asset. As a result, the higher business tax rate overseas from an expected real appreciation of a given asset is not included in these rates.

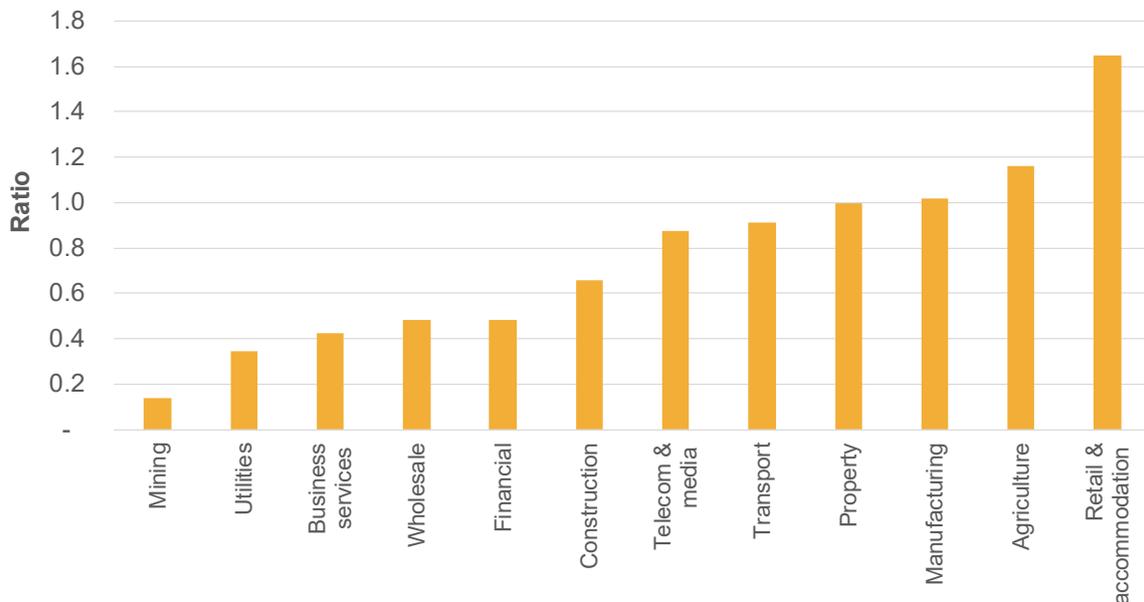
**Figure 6.1: Corporate marginal effective tax rates for manufacturing plants across OECD countries<sup>31</sup>**



Note: DV indicates declining value – e.g. a depreciation rate of 1% DV allows a building owner to claim 1% of the adjusted tax value of an asset each year. Average is for countries shown.

Source: Hanappi (2017)

**Figure 6.2: Ratio of the value of the stock of non-residential buildings relative to the Gross Operating Surplus, by industry**



Source: Stats NZ (National Accounts)

31 This graph is based on the methodology of Hanappi (2017) with comparable New Zealand figures produced by the Secretariat for the Tax Working Group. A 2018 version of this paper has been published by the OECD with New Zealand included, however, the Group has confirmed that it includes an error in the calculation of marginal effective tax rates (METRs) for manufacturing plants, which heavily understated the METR for this investment class. As a result, the 2017 analysis has been used for this report.

### *The treatment of seismic strengthening expenditure*

23. In the course of discussions on building depreciation deductions, the Group has noted that no deductions are allowed for expenditure on seismic strengthening.
24. The current approach results in a counter-intuitive outcome: deductions may be claimed if a building collapses in an earthquake but no deductions may be claimed on expenditure that will prevent the building from collapsing.
25. Even if the Government decides not to reinstate deductions for building depreciation, there is a clear case to allow deductions in some form over time for seismic strengthening.

### Options for building depreciation

26. The revenue impact of reinstating building depreciation deductions will be substantial (even at a depreciation rate of 1%). To manage these costs, the Government could reinstate building depreciation on a partial basis for:
- seismic strengthening only
  - multi-unit residential buildings<sup>32</sup>
  - industrial, commercial and multi-unit residential buildings.
27. The Group does not recommend reintroducing depreciation deductions for standalone residential buildings, as the evidence that such buildings depreciate is weaker than for multi-unit residential, commercial and industrial buildings.

28. Table 6.1 sets out the revenue impacts of these options.

**Table 6.1 Revenue impacts of building depreciation options**

Option	Approximate fiscal cost over 5 years
Restore building depreciation solely for seismic strengthening work on commercial, industrial and multi-unit residential buildings (up to 67% of new building standard, 30-year straight-line deductions).	<b>Total cost</b> \$70 million
Restore building depreciation at 1% on multi-unit residential buildings.	<b>Total cost</b> \$150 million
Restore building depreciation at 1% on industrial, commercial and multi-unit residential buildings.	<i>Industrial</i> \$425 million <i>Commercial</i> \$880 million <i>Multi-unit residential</i> \$150 million <b>Total cost</b> \$1.46 billion

29. The Group notes that restoring depreciation on multi-unit residential buildings could support the Government's housing affordability goals by increasing the supply of housing and supporting greater intensification in urban areas – thereby putting downwards pressure on house prices and rents.
30. The Government might also wish to consider tax measures that encourage building to higher environmental standards. These measures could be funded by revenue from environmental taxes.

<sup>32</sup> Multi-unit residential building refers to a building comprised of multiple residential units (e.g. an apartment block).

## Loss ring-fencing for residential rental property

31. A key argument for the planned introduction of residential rental loss ring-fencing rules has been the lack of a tax on capital gains on rental properties. Landlords are currently able to claim tax losses when they are making untaxed economic profit owing to capital gain.
32. The case for residential rental loss ring-fencing is reduced if the taxation of capital gains is extended to cover residential rental investment property. Gains will be taxed when properties are sold although there will still be some timing benefits for landlords if losses are not ring-fenced because gains are taxed only on realisation.
33. To the extent the taxation of capital gains could put upward pressure on rents, the removal of ring-fencing on residential rental property may aid in limiting potential rent increases.
34. The Group suggests that the Government consider whether or not it wishes to remove loss ring-fencing on residential rental property if the taxation of capital gains is extended to include residential rental investment property. The cost of this policy change is approximately \$830 million over five years and would need to be balanced against the Government's other priorities.

## Nationally significant infrastructure projects

35. The New Zealand Superannuation Fund (NZSF) has suggested the use of a limited tax incentive to spur investment into Government-approved, nationally significant public infrastructure projects that would benefit from unique international expertise.
36. NZSF suggested that investors pay a concessionary rate of 14% (i.e. half of the current company rate of 28%) on profits made in New Zealand from qualifying projects. Qualifying investors would need to have a demonstrated capability to deliver world-class infrastructure

projects; they would also need to bring expertise that is not ordinarily available in New Zealand and commit that expertise to the delivery of the infrastructure.

37. NZSF's suggestion has merit. The Group recommends that the Government consider the development of a carefully designed regime to encourage investment into large, nationally significant infrastructure projects that both serve the national interest and require unique international project expertise to succeed.

## International income taxation

38. The Group has received many submissions about international taxation and the tax practices of multinational companies and digital firms. It is clear from the submissions that many people feel a deep sense of unfairness about the way in which the tax system deals with these firms. This is a worrying phenomenon: perceptions of unfairness have the potential to erode public support for the tax system as a whole.
39. The Group's discussions have focused on issues related to the tax treatment of cross-border revenues from digital services, where some of the sharpest concerns about the taxation of multinational companies have arisen.
40. Since the release of the *Interim Report*, a number of countries – including France and the United Kingdom – have announced their intention to pursue a digital services tax. Australia also recently released a discussion paper on the digital economy and the future of Australia's corporate tax system.
41. New Zealand continues to participate in discussions at the OECD on the future of the international income tax framework.<sup>33</sup> The Group supports New Zealand's involvement in this multilateral process but New Zealand must also be ready to act in its own best interests.

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33 The OECD aims to get G20 approval for the proposals in June 2019 and reach a consensus solution by the end of 2020.

42. The Group recommends that New Zealand stand ready to implement a digital services tax if a critical mass of other countries move in that direction and it is reasonably certain that New Zealand's export industries will not be materially impacted by any retaliatory measures.
43. The Government must also ensure – to the extent possible – that New Zealand's double tax agreements and trade agreements do not unduly restrict our taxation options in these matters.

## Opportunities to reduce compliance costs

44. The Group has heard many concerns about the compliance costs imposed by the tax system, particularly on small businesses. In their response to the *Interim Report*, the Ministers of Finance and Revenue also asked the Group to provide an expanded list of opportunities for reducing compliance costs.
45. Following consultation with submitters and discussions with business representatives, the Group has identified a set of opportunities for immediate action. These are:
- an increase in the threshold for provisional tax from \$2,500 to \$5,000 of residual income tax
  - an increase in the closing stock adjustment from \$10,000 to \$20,000 - \$30,000
  - an increase in the \$10,000 automatic deduction for legal fees and a potential expansion of the automatic deduction to other types of professional fees (but not to other potential capital expenditure, such as repairs and maintenance)
  - a reduction in the number of depreciation rates and a simplification of the process for using default rates.
46. In addition to these opportunities, the Government should consider the merits of adjusting the thresholds for both unexpired expenditure and the write-off of low-value assets.

47. Subject to fiscal constraints, the Group also recommends that the Government:
- simplify the fringe benefit tax and simplify (or even remove) the entertainment adjustment
  - remove resident withholding tax on close company-related party interest and dividend payments, subject to integrity concerns
  - remove the requirement for taxpayers to seek the approval of the Commissioner of Inland Revenue to issue GST buyer-created tax invoices
  - allow special rate certificates and certificates of exemption to be granted retrospectively
  - increase the period of validity for a certificate of exemption or special rate certificate
  - remove the requirement to file a change of imputation ratio notice with Inland Revenue
  - extend the threshold of 'cash basis person' in the financial arrangement rules, which would better allow for the current levels of personal debt
  - increase the threshold for not requiring a GST change-of-use adjustment.

48. The Government should also explore opportunities to help reduce compliance costs for small businesses through the use of cloud-based accounting software. Regimes (such as the rules for the deductibility of entertainment expenditure) should be designed through the lens of 'automation first' – meaning that any new set of rules created should be easily programmable to reduce compliance costs.

## Compensating withholding agents

49. Withholding taxes can be an effective approach to minimising the overall compliance and administrative costs of a tax. However, they impose compliance costs and risks on withholding agents. The Group notes that some countries give withholding agents administrative fees to compensate for taking on risk and the costs of compliance and this could be considered if additional withholding tax obligations are imposed.

## Non-resident employees

50. The Group recommends a review of the taxation of non-resident employees. There is a particular problem when such employees are frequently in and out of the country and it is unclear whether they will breach the 92-day or 183-day thresholds for taxation. It would be desirable to simplify the obligations relating to these employees, for example, by requiring employers to consider the taxation of genuinely transitory non-resident employees at year-end only.

## Hybrid mismatch rules

51. There are also issues with the hybrid mismatch rules. These rules deal with cross-border arrangements that can exploit differences in the tax treatment of instruments across jurisdictions. The current rules appear to be creating some unintended compliance issues for small businesses. The Group recommends that the Government review whether these rules should apply to small businesses or simple business transactions (such as the transfer of trading stock and the utilisation of losses).

## The taxation of retirement savings

52. Individuals save for a variety of reasons. The saving and investment choices of firms, individuals and the Government – aggregated across the economy – shape the accumulation of financial and physical capital in New Zealand. Rates of private saving therefore have broader impacts on the performance of the New Zealand economy.

53. There are many reasons for individuals to save. One of the primary motivations is the need to ensure an adequate standard of living in retirement. The Group considered the tax treatment of retirement savings in the *Interim Report* and concluded that there is not a case to radically reform the current arrangements. However, the Group's view is that an increase in the tax benefits provided through KiwiSaver would encourage more people to save for their retirement.

54. The Group has discussed a range of possibilities to encourage low-income earners to save. The Group also recognises that non-tax measures (such as adjustments to the design parameters of the KiwiSaver scheme and income adequacy measures arising from the work of the Welfare Expert Advisory Group) could also promote greater saving. Within the tax system, an illustrative set of options could include:

i. **A contribution-based tax benefit**, which could take one or more of the following forms:

- **Employer's superannuation contribution tax (ESCT).** Inland Revenue would refund ESCT for KiwiSaver members earning up to \$48,000 per annum. The ESCT would be refunded to the taxpayer's KiwiSaver account. The refund would be progressively clawed back for employees earning more than \$48,000 per annum, so that employees earning over \$70,000 would receive no benefit. This is a modification of the capped ESCT exemption that was discussed in the *Interim Report*.
- **Parental benefit.** A KiwiSaver member on parental leave would receive the maximum member tax credit, even if they did not make the full \$1,042 of contributions.
- **Member tax credit.** An increase in the member tax credit from \$0.50 per \$1 of contribution to \$0.75 per \$1 of contribution. The contribution cap would remain unchanged at \$1,042.

ii. **PIE rate reductions.** A five percentage point reduction in the lower PIE rates for KiwiSaver funds (i.e. the 10.5% and 17.5% rates). As discussed in the *Interim Report*, the schedule of PIE rates should also be simplified.

55. The Group notes that, as lifespans have increased, people are now spending a much greater proportion of their lives in retirement. Although the Group has decided it is not necessary to adjust the tax system for inflation, we have identified a need for further work on options to maintain the purchasing power of people's savings through their retirement.

## The taxation of the New Zealand Superannuation Fund

56. During its discussions on retirement savings, the Group noted the oddity that the NZSF must pay tax to the New Zealand Government. The NZSF reports that it paid \$1.2 billion in tax, or 9% of New Zealand's corporate tax take, in the 2016-17 tax year (New Zealand Superannuation Fund, 2017).
57. This treatment is unusual from an international perspective. Government investment funds in other countries are not generally subject to tax. It is also notable that the New Zealand Government's other large investment funds – the investment fund of ACC and the Natural Disaster Fund of the Earthquake Commission – are not subject to tax.
58. The NZSF's tax status in New Zealand affects its tax status in some foreign jurisdictions. Some countries recognise the principle of sovereign immunity from taxes – meaning that a government should not be subject to tax when it invests in another government's jurisdiction. It is more difficult to argue that the NZSF should benefit from sovereign immunity when it is subject to tax in its home jurisdiction. The NZSF reported paying approximately \$14 million in tax to foreign governments in the 2016-17 tax year (New Zealand Superannuation Fund, 2017). This is a cost to the NZSF that does not benefit New Zealand.
59. Tax-exempt status would better recognise the fact that the NZSF is an instrument of the Government of New Zealand and make it easier for the NZSF to apply for tax exemptions in foreign countries where they are available. Not all governments recognise the principle of sovereign immunity, so the NZSF may still have to pay tax in some jurisdictions, even if it becomes tax-exempt in New Zealand. Nevertheless, the NZSF will benefit from lower compliance costs in New Zealand and some reduction in foreign taxes.

60. Tax-exempt status would also reduce the amount of contributions that need to be made by the Government over time in terms of the funding formula in the New Zealand Superannuation and Retirement Income Act 2001.
61. The Group therefore recommends that the Government give favourable consideration to specifically exempting the NZSF from New Zealand tax obligations on the basis it is an instrument of the Government of New Zealand.

## Summary assessment

62. The current approach to the taxation of business is largely sound. The Group does not see a case at this time to reduce the company rate or to move away from the imputation system. However, the Government should continue to monitor developments in company tax rates around the world, particularly in Australia. The tax rate for Māori authorities also remains appropriate (although the rate should be extended to the subsidiaries of Māori authorities). The Group recommends against the introduction of a progressive company tax.
63. The Group has investigated a number of options for tax reform that could enhance productivity and boost investment. These include measures such as changes to the loss-continuity rules, an expansion of black-hole deductions, building depreciation deductions, removal of residential rental loss ring-fencing, and concessions for nationally significant infrastructure projects. Some or all of these measures could form part of a package of tax reform, alongside an extension of capital gains taxation.
64. New Zealand currently offers few tax incentives for retirement savings. The Group does not see a case to radically reform the taxation of retirement savings but an increase in the tax benefits for low- and middle-income earners provided through KiwiSaver would encourage people to put more away for their retirement. There is also a case to exempt the NZSF from New Zealand tax obligations.



# 7

## Personal income tax

1. Personal income tax is the largest source of revenue for the Government. It is also – alongside GST – the primary way in which most New Zealanders interact with the tax system. The fairness and integrity of the personal income tax regime therefore bears directly on New Zealanders' views of the fairness and integrity of the tax system as a whole.
4. Non-employees – whether operating as businesses or as contractors – receive the opposite treatment. They receive deductions for work-related expenses and generally need to register for GST. There are, however, various levels of withholding tax on some contractors. Common law tests determine the employment status of an individual for tax purposes; consequently, the taxable status of an individual may differ from their contractual status.

### The current approach to personal income taxation

2. Personal income tax applies to individuals. It is the ultimate tax paid by individuals after income has worked its way through the various taxable entities and structures, taking the form of wages, salaries, self-employed income, dividends, interest and other income.
3. Most personal income tax is collected from employees. Employees do not receive any deductions for work-related expenses. (Nor are they required to register for GST.) Income tax on employee salaries and wages is withheld at source, so most employees do not need to file tax returns.<sup>34</sup>

5. Unlike the other tax bases, personal income tax has a progressive rate structure.<sup>35</sup> The current rates and thresholds are as follows:

**Table 7.1: Personal income tax rates and thresholds**

Taxable income	Tax rate
0 – \$14,000	10.5%
\$14,001 – \$48,000	17.5%
\$48,001 – \$70,000	30%
\$70,001 +	33%

6. Two-thirds of taxpayers earn less than \$48,000 and therefore have incomes below the second tax threshold.

<sup>34</sup> Some employees, however, are subject to an 'end-of-year square up' for other items, such as social policy entitlements or earnings from which tax has not been withheld. For the 2016-17 tax year, approximately 2.4 million individuals received personal tax summaries or filed an IR3 returns. Approximately 1.4 million people with PAYE income (excluding interest income) did not file returns. From the 2018-19 tax year, Inland Revenue will automatically calculate individuals' income tax liability based on information it holds (subject to legislation being enacted).

<sup>35</sup> A progressive rate structure is one where the proportion of income paid in tax rises as income rises.

Table 7.2: The distribution of taxpayers (2017)

Taxable income bracket	Number of people in each bracket	Percentage of people in each bracket
0-\$14,000	787,190 <sup>36</sup>	20.9%
\$14,001-\$48,000	1,720,580	45.6%
\$48,001-\$70,000	612,200	16.2%
Over \$70,000	655,360	17.4%

Source: Inland Revenue

## The rates and thresholds of income tax

7. In their response to the *Interim Report*, the Ministers of Finance and Revenue asked the Group to develop measures that would reduce inequality and increase the fairness of the tax system. This has informed the Group's consideration of personal income tax settings.
8. In the *Interim Report*, the Group noted that any changes to personal income taxation would need to reflect the specific objectives of the Government:
  - If the Government wishes to improve incomes for very low-income households, the best means of doing so would be through welfare transfers.
  - If the Government wishes to improve incomes for certain groups of low- to middle-income earners, such as full-time workers on the minimum wage, then cuts in lower marginal tax rates or increases in lower tax thresholds can provide support for these groups and make personal income taxes more progressive. All higher-income groups would also benefit but low- to middle-income earners would receive the largest proportional benefits.
9. The extent of any changes to personal income taxation will also require trade-offs and prioritisation against other tax reform measures.

10. The following sections of this chapter present a set of options, all of which include benefits for low- to middle-income earners. The Group has not considered a reduction in the top marginal rate because it is already low by international standards and the Group does not wish to reduce the progressivity of the tax system on vertical equity grounds.
11. The transfer system, in its current state, includes tax credit payments, as well as benefit payments. Changes to transfer settings are outside the Group's Terms of Reference. The Welfare Expert Advisory Group (WEAG) is reviewing the welfare system and is expected to release its final report with recommendations by February 2019. The Tax Working Group recommends that any changes to tax rates and thresholds be considered alongside any recommendations made by the WEAG.

## Options for personal income taxation

### Tax-free thresholds

12. A tax-free threshold establishes a dollar amount limit under which no income tax is payable. Tax-free thresholds are a feature of many tax systems around the world. In Australia, for example, the first \$18,200 of annual income is not taxed. The usual motivation for a tax-free threshold is to enhance the progressivity of the tax system, although in many countries social security taxes still apply in this threshold.

### Policy assessment

13. If the Government adopts in full the recommendations of the Tax Working Group on capital gains taxation and \$1.6 billion (per annum) was earmarked to establish a tax-free personal income threshold, then that threshold could be set at around \$5,000 a year by 2022-23. This would be equivalent to a tax cut of about \$10 a week at and above that threshold.

<sup>36</sup> This includes 95,000 people on nil income. People with negative income because of losses are recorded as having nil taxable income in the tables.

14. It should be noted, however, that beneficiaries, other than New Zealand Superannuitants, would not receive any increase in their net income because of the way benefits are calculated under the current law. If the law were to be changed, so that such beneficiaries were to receive the same post-tax increase as other people on the same income, the cost would increase to approximately \$1.8 billion per annum.
15. A tax-free threshold would increase the net income of many low-income earners. However, it would also benefit people in *households* that are not necessarily low income. Approximately 570,000 income earners aged over 15 earn less than \$14,000 per annum (the bottom tax threshold).<sup>37</sup> Of these, 46% are secondary earners in households that earn above median income.
16. This suggests that while a tax-free threshold could increase the net income of many low-income households, much of the increase would also flow through to higher-income households.
17. Transfers such as tax credits and benefit payments are likely to be a better means of delivering assistance to people on low incomes and the Group is aware that the WEAG is considering these options in its deliberations.
19. The Group prefers increasing the bottom threshold to introducing a tax-free threshold due to the support the threshold adjustment gives for those transitioning into work, and the risk that more of the increase in income from the tax-free threshold will also flow through to higher-income households.
20. The Group has developed a number of illustrative options to aid the Government's considerations. In setting the scale of these illustrative options, the Group has been aware of the total revenue projected to be generated by extending the taxation of capital gains (as discussed further in Chapter 8).
21. Option 1a involves an increase in the bottom threshold from \$14,000 to \$22,500, while Option 1b involves an increase in the bottom threshold to \$20,000 (to reduce the revenue impact). Table 7.3 illustrates the resulting changes to the thresholds.
22. An alternative approach would combine an increase in the bottom threshold with an increase in the second marginal rate. The increase in the second marginal rate would generate additional revenue to allow for a more significant increase in the bottom threshold. Under Option 2, an increase in the bottom threshold to \$30,000 is combined with an increase in the second marginal tax rate to 21% from 1 April 2021. The resulting fiscal cost is similar to Option 1a. Table 7.4 illustrates the resulting changes to the rate and threshold.

## Rate and threshold adjustments

18. Working within the Tax Working Group's Terms of Reference, an alternative approach to enhancing the progressivity of the tax system would be to increase the bottom threshold of personal tax. This would reduce the marginal tax rate of those on low incomes transitioning into work, which a tax-free threshold would not. For the same fiscal cost, this approach could also deliver a bigger tax break for many individuals transitioning into work, relative to a tax-free threshold. An increase in the bottom threshold could also reduce the instances of some low-income earners with more than one job facing a higher secondary tax rate.
23. The Terms of Reference rule out increases to any rate of personal income tax. However, the Group has raised this possibility because it would generate greater benefits for lower-income earners than the other options, while also reducing average tax rates for higher-income individuals – ensuring that no one is left worse off as a result of the change.

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<sup>37</sup> According to the Household Economic Survey in 2017. This excludes individuals with zero income (and no negative sources of income).

Table 7.3: Potential personal income tax changes – Options 1a and 1b

Status quo income brackets	Option 1a income brackets	Option 1b income brackets	Tax rate (%)
0 – \$14,000	0 – \$ <b>22,500</b>	0 – \$ <b>20,000</b>	10.5
\$14,001 – \$48,000	\$22,501 – \$48,000	\$20,001 – \$48,000	17.5
\$48,001 – \$70,000	\$48,001 – \$70,000	\$48,001 – \$70,000	30
\$70,001 +	\$70,001 +	\$70,001 +	33

Table 7.4: Potential personal income tax changes – Option 2

Status quo income brackets	Status quo tax rate (%)	Option 2 income brackets	Option 2 tax rate (%)
0 – \$14,000	10.5	0 – \$ <b>30,000</b>	10.5
\$14,001 – \$48,000	17.5	\$30,001 – \$48,000	<b>21</b>
\$48,001 – \$70,000	30	\$48,001 – \$70,000	30
\$70,001 +	33	\$70,001 +	33

## Policy assessment

### *Equity and fairness impacts*

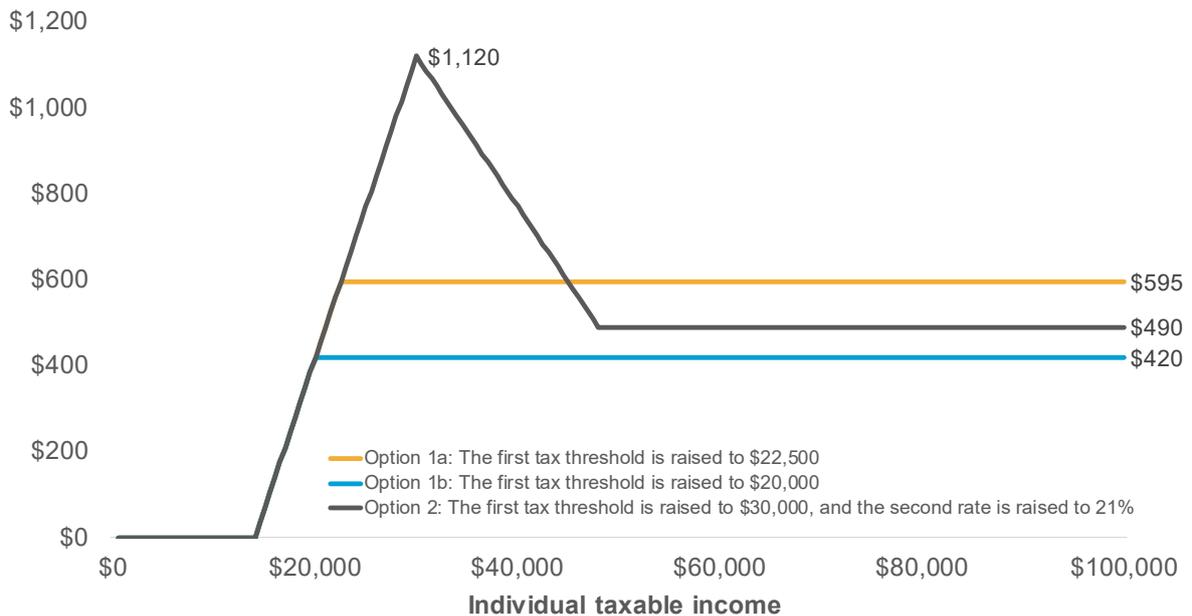
24. Under each of the options, all individuals earning more than \$14,000 would benefit with most of those earning closer to \$14,000 receiving a proportionally greater increase in their take-home pay than those on higher incomes. These impacts are illustrated in figure 7.1.

- With Option 1a, individuals earning between \$14,000 and \$22,500 would gain between \$0 and \$595 per year and all higher-income earners would gain \$595.
- With Option 1b, individuals earning between \$14,000 and \$20,000 would gain between \$0 and \$420 per year and all higher-income earners would gain \$420. This option has a lower fiscal cost than the others considered.
- With Option 2, individuals earning between \$14,000 and \$30,000 would gain between \$0 and \$1,120 per year. If their income is between \$30,000 and \$48,000, their gain would be between \$490 and \$1,120. Higher income people earning more than \$48,000 gain \$490 per year.

25. Option 2 provides greater gains than Option 1a for those earning between \$22,500 and \$45,000. This occurs because individuals earning more than \$45,000 gain less in Option 2 compared to Option 1a and this relatively lower gain is redistributed to the lower income earners. Under every option, all individuals earning more than \$14,000 will benefit but individuals on lower incomes would generally benefit proportionally more than higher-income individuals.

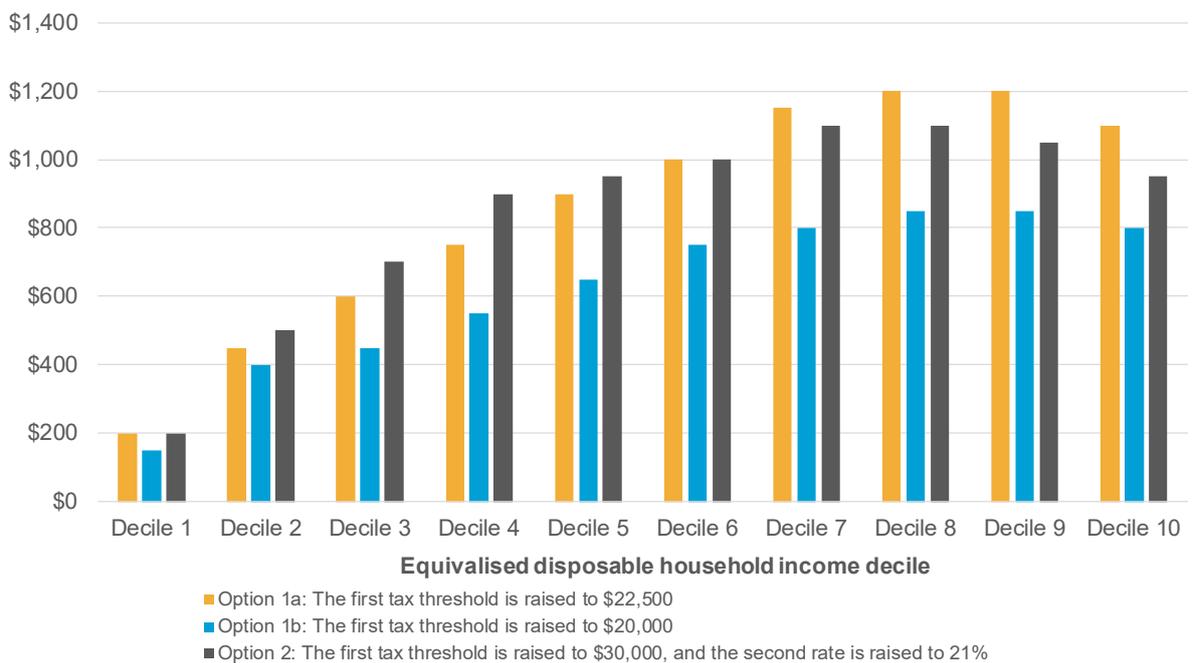
26. Under each of the options, average tax rates fall for all individuals currently with incomes greater than \$14,000. In equivalised household incomes, figure 7.2 shows that the greatest dollar gains to lower-income households come from Option 1a and Option 2. Under every option, households in the lowest income deciles generally gain proportionally more than households in higher income deciles.

**Figure 7.1: Annual benefit to individuals from personal income tax changes**



Source: Inland Revenue

**Figure 7.2: Average change in household disposable income from personal income tax changes, by income decile<sup>38</sup>**



Source: The Treasury

<sup>38</sup> The average gain is higher for households in decile 9 relative to decile 10 because of household composition effects: households in decile 10 typically consist of one or two high income earning persons, whereas households in decile 9 have more multi-family households with more earners per household on average.

27. Table 7.5 illustrates the average gains delivered by each option to different types of households.
28. Options 1a and 2 have very similar impact profiles on these types of households. Couples and multi-family households gain the most from the tax changes because, on average, they have more than one income earner.
29. Overall, adjustments to the bottom rates and thresholds would increase the progressivity of personal income tax. The Group notes, however, that the personal tax changes that have been discussed are likely to have only a minor impact on income inequality as measured by the Gini coefficient. For example, Option 2 would have the greatest impact on progressivity of the three options considered, however, this would only decrease the Gini coefficient from 0.3272 to 0.3255 (a 0.5% decrease).

#### Interactions with the transfer system

As a matter of fairness, the Group recommends that income tax reductions should benefit all low-income households – including households on benefits. At the moment, some benefits are set to ensure that beneficiaries receive a given level of income after tax so there is no change in net benefit levels as a result of tax changes. Any tax reductions should be paired with equivalent increases in benefit levels to ensure fair treatment of all income earners. The fiscal cost of this has not been included in our package costings.

**Table 7.5: Average gain per household by household type (2022/23)**

	Option 1a The first tax threshold is raised to \$22,500	Option 1b The first tax threshold is raised to \$20,000	Option 2 The first tax threshold is raised to \$30,000 and the second rate is raised to 21%
<b>Average gain in annual disposable income relative to the status quo settings</b>			
Couple with children	\$900	\$650	\$850
Couple without children	\$900	\$650	\$900
Multi-family with children	\$1,200	\$850	\$1,200
Multi-family without children	\$1,250	\$900	\$1,300
Single without children	\$400	\$300	\$350
Sole parent	\$300	\$200	\$350

Note: A 'couple household' is defined as one family with two non-dependants (with or without dependants, or children); a 'multi-family' household consists of more than one family; a 'sole parent' household consists of a single family with one non-dependant and at least one dependant.

Source: The Treasury

**Table 7.6: Five-year fiscal costs of options**

	Option 1a The first tax threshold is raised to \$22,500	Option 1b The first tax threshold is raised to \$20,000	Option 2 The first tax threshold is raised to \$30,000 and the second rate is raised to 21%
Revenue impact	\$8.3 b	\$6.1 b	\$8.3 b

Source: The Treasury

### *Efficiency impacts*

30. Reductions in the bottom rates and raised thresholds of income tax should enhance efficiency. Evidence points to small reductions in economic efficiency from higher average tax rates but high effective marginal tax rates can have significant impacts on certain groups of people, such as people who are on the edge of moving between benefits and work.
31. Effective marginal tax rates are already high for some households receiving Working for Families tax credits. If the second marginal rate is raised to 21%, effective marginal tax rates might increase even further for some households. If this higher tax rate is adopted, the Group suggests that the Government consider a reduction of the abatement rate of Working for Families tax credits to offset the impact of the increase.
32. Factors that affect work decisions can also affect decisions on saving and investment, upskilling, and the general development of human capital.

### *Revenue impacts*

33. Since changes in the bottom rates or thresholds carry through to all individuals, even small changes can have large revenue impacts.
34. Table 7.6 presents the revenue impacts of the options, over the five years from 2021-22 to 2025-26. Options 1a and 2 are similar in fiscal cost over the five-year period to 2025-26.

### *Other impacts*

35. The Group sees no significant compliance, administration or integrity issues arising from changes to the lower rates or thresholds of personal income tax.

## **Summary assessment**

36. Any changes to personal income taxation would need to reflect the objectives of the Government.
  - If the Government wishes to improve incomes for very low-income households, the best means of doing so would be through welfare transfers.

- If the Government wishes to improve incomes for certain groups of low- to middle-income earners, such as full-time workers on the minimum wage, then changes to personal income taxation may be a better option.

37. The Group has discussed a range of options to increase the progressivity of the personal tax system. The Group's preferred approach is to increase the bottom tax threshold. This could potentially be combined with an increase in the second marginal tax rate.
38. The Group prefers increasing the bottom threshold to introducing a tax-free threshold owing to the support the threshold adjustment gives to those transitioning into work and the risk that more of the increase in income from a tax-free threshold will flow through to higher income households.
39. The Group considers that tax credits and benefit payments are likely to be a better means of delivering assistance to low-income households than tax rate or threshold changes. In that context we note the Terms of Reference of the WEAG. The Government will need to consider the WEAG's recommendations alongside those of the Tax Working Group.
40. Changes in personal income taxation do not lead to changes in beneficiary incomes. If tax changes are introduced that are intended to increase household incomes at the bottom of the income distribution, the Government should consider a corresponding increase in net benefit payments. This would provide a fairer redistribution of income across individuals.
41. Overall, the personal tax changes discussed in this report are likely to have a minor impact on income inequality. A material reduction in income inequality through the personal tax system would require broader income tax changes, including an increase in the top personal marginal rate. Such a change is beyond the scope of the Group's Terms of Reference.



# 8

## Illustrative packages to improve the structure, fairness and balance of the tax system

1. A broad extension of capital gains taxation (as set out in Volume II) is projected to raise approximately \$8.3 billion over the first five years from introduction. The revenue is expected to increase over time, although it will also be volatile. In light of these revenue projections, the Group has been directed to develop revenue-neutral packages of tax reform for the Government's consideration.
2. In their response to the *Interim Report*, the Ministers of Finance and Revenue specified that these packages should reduce inequality and increase fairness across the tax system. The packages should also improve housing affordability, promote a more balanced savings culture, and deepen capital markets. The Group has developed a range of illustrative packages that are directed towards these goals.
3. The best use of revenue from extending capital gains taxation, however, will ultimately depend on the Government's priorities. Tax reform is only one choice; the Government also has a wider set of options to consider beyond the tax system. Ministers will need to assess the options for tax reform against other needs and priorities to determine what would best enhance the wellbeing of New Zealanders.

### Illustrative packages

4. The Group has developed four illustrative packages for the Government's consideration:
  - A package that increases progressivity through reductions in personal income tax.
  - A package with a greater focus on measures to support businesses and housing affordability.
  - A package with a greater focus on supporting savers, particularly those on lower incomes.
  - A package with a more diversified focus, where business tax measures are deferred to enable greater savings measures.
5. All four of the packages are broadly revenue-neutral over five years.<sup>39</sup> While each package focuses on different themes, they all involve substantial reductions in personal income tax that deliver the greatest proportional benefits to lower-income earners.
6. These packages are intended as examples to illustrate the tax measures that are available to the Government. Depending on its objectives, the Government could combine these or other measures into alternative packages for tax reform.

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<sup>39</sup> Revenue-neutral for this chapter is considered by taking the total projected additional revenue from extending capital gains taxation when added up over the first five years and comparing with the total cost of revenue-negative measures when added up over the same five years.

## The main building blocks of the packages

### Revenue from extending capital gains taxation

7. The revenue estimates are highly uncertain but a broad extension of capital gains taxation is projected to raise approximately \$8.3 billion over five years. The revenue is expected to increase over time but it will also be volatile. This volatility will require disciplined fiscal management, so that future governments do not lock themselves into permanent spending commitments on the basis of temporary peaks in capital gains taxation revenue.

### Revenue arising from other Group recommendations

8. In the *Interim Report*, the Group proposed a range of measures that would increase revenue by enhancing integrity and improving collection in the tax system.<sup>40</sup> It is not possible to estimate the revenue benefits of these measures with precision, so the Group has not included them in the packages considered here.
9. Nevertheless, the revenue benefits of these measures could be significant. Cabral and Gemmel (2018) estimate that, on average, the self-employed under-report 20% of their income. Under a fairly conservative set of assumptions, this could represent foregone revenue of around \$850 million per annum or 0.3% of GDP.<sup>41</sup> The actual revenue foregone could be even greater still.
10. Similarly, Chapter 4 *Environmental and ecological outcomes* identifies a range of opportunities for expanding environmental taxation. These opportunities could deliver significant revenue

benefits to the Government. However, most of this revenue potential will emerge over the medium to long term and is thus beyond the five-year window for the packages considered in this chapter.

11. Also, the Group supports recycling some or all of the revenue from environmental taxation into measures that would support a transition to a more environmentally sustainable economy. Environmental taxes should therefore be considered as a complementary set of reforms to the packages presented in this chapter.

### Revenue-reducing measures

12. Previous chapters of this report have discussed the main revenue-reducing measures for inclusion in a package of tax reform. Table 8.1 summarises the main measures and their approximate revenue cost over the five-year period of the packages.

## The shape of the packages

13. Table 8.2 outlines the four packages developed by the Group. These packages are illustrative only and are intended to provide a sense of the options available to the Government to consider, rather than serve as a definitive blueprint for the Government to follow.
14. As a matter of fairness, the Group considers that income tax reductions should benefit all low income households – including households on benefits. The tax reductions in each package should be paired with equivalent increases in benefit levels to ensure a fair treatment of all income earners.

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40 These integrity measures are summarised in Chapter 9 *Other opportunities to improve the tax system*.

41 This estimate only relates to self-employed people who are sole traders or in a partnership. Estimating the potential revenue foregone for all self-employed is not possible using the methodology by Cabral and Gemmel as consumption by shareholder employees can be funded legitimately through loans by companies. Revenue estimate is for 2016.

**Table 8.1: Revenue-reducing measures**

Item	Key benefit	Approximate revenue cost over 5 years
<b>Savings measures</b>		
Remove ESCT on employer's matching contribution of 3% of the salary to KiwiSaver, for members earning up to \$48,000 per year.	Provide support to low-income savers.	\$1.1 billion
Remove ESCT on employer's matching contribution of 3% of the salary to KiwiSaver. The amount of ESCT that is exempt is reduced by 6 cents per dollar of income over \$48,000 (so no exemption for employees earning over \$70,000).	Provide support to low-income savers. Remove fiscal 'cliff' of above option.	\$1.7 billion
Reduce lower PIE rates by five percentage points for KiwiSaver funds (5.5%, 12.5%, 28%).	Provide support to low-income savers.	\$630 million
Increase member tax credit from \$0.50 per \$1 of contribution to \$0.75 per \$1 of contribution.	Provide support to savers.	\$2.6 billion
Primary caregiver KiwiSaver member receives full member tax credit in year of child's birth regardless of their KiwiSaver contributions.	Provide support to savers, in particular, women during maternity.	\$70 million
<b>Business tax and housing measures</b>		
Restore building depreciation on commercial, industrial and multi-unit residential buildings. <i>Fiscal costs in this table assume a 1% diminishing value depreciation rate.</i>	Increase neutrality of investment by reducing the tax cost of investing in buildings and building-owning businesses. Encourage supply of multi-unit rental accommodation.	<i>Commercial</i> \$880 million <i>Industrial</i> \$425 million <i>Multi-unit residential</i> \$150 million
Restore building depreciation solely for seismic strengthening work (up to 67% of new building standard, 30 year straight-line deductions).	Provide support to property owners undertaking seismic strengthening work.	\$70 million
Expand deductibility for 'black-hole' expenses. <i>Fiscal costs in this table are with a five year spreading of expenses.</i>	Increase neutrality of investment by improving incentives for innovation and risk-taking.	\$120 million
Remove residential rental loss ring-fencing restrictions.	Reduce upward pressure on rents and encourage more investment in rental housing.	\$830 million
Reduce restrictions on loss carry-forwards when a company is sold.	Improve incentives for innovation and risk-taking.	\$240 million
<b>Total fiscal cost</b> (excluding personal income tax reductions and mutually exclusive measures).		\$7.6 billion
<b>Personal income tax reductions</b>		
Personal income tax reductions (i.e. increase in bottom threshold).	Support those on lower incomes. May result in modest improvements in incentives to work and save.	Depends on level of income tax reduction.

Revenue estimates are preliminary and indicative. Revenue estimates are based on specific assumptions and design features. As a result, estimates may change with further design and if better information becomes available.

**Table 8.2: Illustrative packages**

<b>Package 1: Increasing progressivity through reductions in personal income tax</b>		
<b>Personal income tax reductions</b>	<b>Savings measures</b>	<b>Depreciation deductions</b>
<p>\$6.8 billion<sup>42</sup></p> <p>1. Increase bottom personal income tax threshold to \$22,500 from 1 April 2022.</p> <p>or</p> <p>2. Increase bottom personal income tax threshold to \$30,000 and increase second rate to 21% from 1 April 2022.</p>	<p>\$1.8 billion</p> <p>1. ESCT exemption for those earning less than \$48,000.</p> <p>2. Reduce lower PIE rates for KiwiSaver by five percentage points.</p> <p>3. Enable primary caregivers to receive full member tax credit during maternity, regardless of contributions.</p>	<p>\$70 million</p> <p>1. Depreciation deductions for seismic strengthening work to bring buildings to 67% of new building standard (spread over 30 years).</p>
<b>Package 2: Business and housing focus</b>		
<b>Personal income tax reductions</b>	<b>Savings measures</b>	<b>Business tax and housing measures</b>
<p>\$3.8 billion</p> <p>1. Increase bottom personal income tax threshold to \$20,000 from 1 April 2023.</p>	<p>\$1.8 billion</p> <p>1. ESCT exemption for those earning less than \$48,000.</p> <p>2. Reduce lower PIE rates for KiwiSaver by five percentage points.</p> <p>3. Enable primary caregivers to receive full member tax credit during maternity, regardless of contributions.</p>	<p>Business tax measures \$1.7 billion</p> <p>1. Reintroduce depreciation deductions for commercial and industrial buildings (1% DV rate).</p> <p>2. Enable deductions for black-hole expenditure.</p> <p>3. Reduce restrictions on loss-continuity.</p> <p>Housing measures \$1 billion</p> <p>1. Reintroduce depreciation deductions for multi-unit residential buildings (1% DV rate).</p> <p>2. Remove residential rental loss ring-fencing.</p>
<b>Package 3: Saving focus</b>		
<b>Personal income tax reductions</b>	<b>Savings measures</b>	<b>Depreciation deductions</b>
<p>\$3.8 billion</p> <p>1. Increase bottom personal income tax threshold to \$20,000 from 1 April 2023.</p>	<p>\$5 billion</p> <p>1. Increase member tax credit from \$0.50 per \$1 of contribution to \$0.75 per \$1 of contribution.</p> <p>2. ESCT exemption for those earning less than \$48,000. Exemption abates at 6 cents per dollar for every dollar earned above \$48,000.</p> <p>3. Reduce lower PIE rates for KiwiSaver by five percentage points.</p> <p>4. Enable primary caregivers to receive full member tax credit during maternity, regardless of contributions.</p>	<p>\$70 million</p> <p>1. Depreciation deductions for seismic strengthening work to bring buildings to 67% of new building standard (spread over 30 years).</p>

42 The fiscal cost of income tax reductions in this table are different to those outlined in Table 7.6. This is because this table looks at the cost of the reductions from the proposed application date (1 April 2022 or 2023) to 2026 while Table 7.6 looked at the fiscal cost over five years starting 1 April 2021.

Package 4: Diversified focus		
Personal income tax reductions	Savings measures	Business tax and housing measures
\$3.8 billion 1. Increase bottom personal income tax threshold to \$20,000 from 1 April 2023.	\$2.4 billion 1. ESCT exemption for those earning less than \$48,000. Exemption abates at 6 cents per dollar for every dollar earned above \$48,000. 2. Reduce lower PIE rates for KiwiSaver by five percentage points. 3. Enable primary caregivers to receive full member tax credit during maternity, regardless of contributions.	Business tax measures \$1.1 billion, applying from 2023-24 tax year 1. Reintroduce depreciation deductions for commercial and industrial buildings (1% DV rate). 2. Enable deductions for black-hole expenditure. 3. Reduce restrictions on loss-continuity. Housing measures \$900 million 1. Reintroduce depreciation deductions for multi-unit residential buildings (applying from 2023-24 tax year). 2. Remove residential rental loss ring-fencing (from 2021-22 tax year).

## Impact assessment

### Impacts common to all packages

15. All of the packages involve a broad extension of capital gains taxation, alongside the Group's recommendations on integrity and compliance cost reductions. This means all of the packages would deliver a common set of impacts in the following areas as a result of the extension of capital gains taxation:

- **Equity and fairness.** Would increase horizontal equity and increase the progressivity of the tax system, particularly in relation to wealth.
- **Efficiency and productivity.** Is likely to improve the allocation of investment across the economy but it would also reduce after-tax returns and create lock-in effects. The impacts would differ across sectors and individuals. The aggregate effects on efficiency and productivity would ultimately depend on how the revenue generated by the additional taxation is used.
- **Housing market.** There could be an increase in rents and a decrease in house prices but any impact is likely to be small.

- **Savings.** There would be a more equal tax treatment of different forms of savings. However, an extension of capital gains taxation would increase the overall level of taxation on savings.
- **Revenue integrity.** There would be reduced incentives and fewer opportunities for tax avoidance and minimisation.

### Package-specific impacts

16. The following section considers the impacts from package-specific measures.

### Distributional impacts and inequality (social capital)

17. All four packages have a focus on personal income tax reductions. These reductions would further increase the progressivity in the tax system and provide modest benefits to most households.

18. Packages 2, 3 and 4 increase the bottom personal tax threshold to \$20,000. This would provide an additional \$420 per annum (\$8 per week) to individuals with annual taxable incomes above \$20,000. Those earning between \$14,000 and \$20,000 would receive a smaller benefit, for example, those earning \$17,000 would receive an additional \$210 per annum (\$4 per week).
19. Package 1 provides greater income tax reductions. Increasing the bottom threshold to \$22,500 would provide an additional \$595 per annum (\$11.40 per week) to individuals with annual taxable incomes above \$22,500.
20. The alternative option (increasing the bottom threshold to \$30,000, while increasing the second rate to 21%) would provide an additional \$1,120 (\$21.50 per week) to those earning \$30,000 and \$490 per annum to those earning more than \$48,000 (\$9.40 per week).

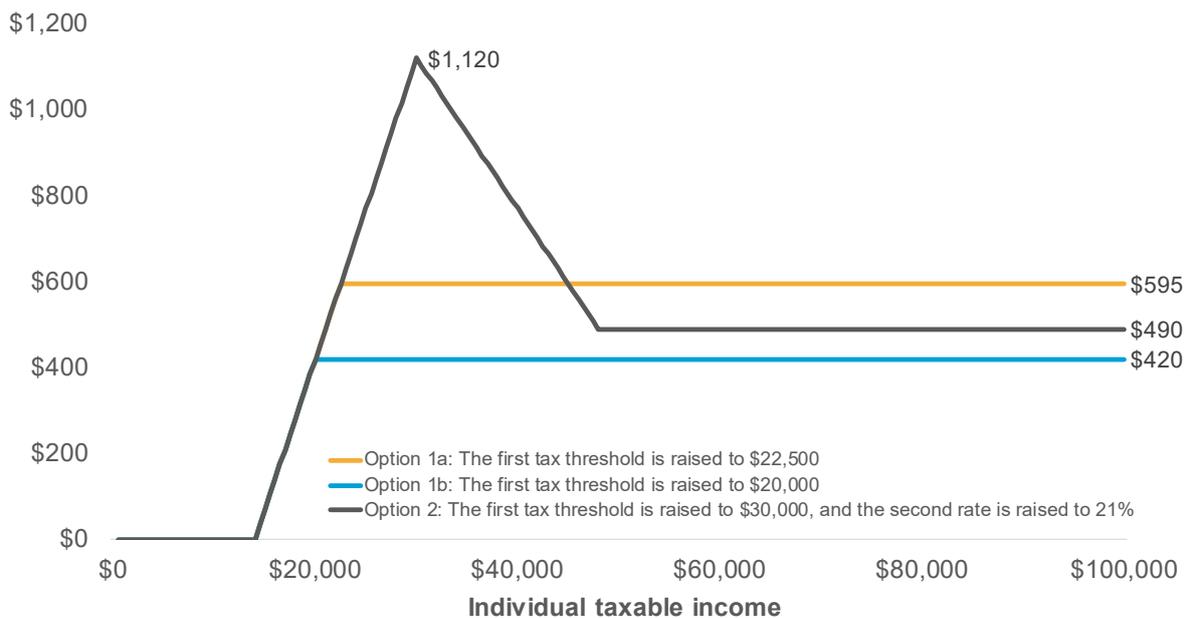
promote investment, economic efficiency and productivity. For example, reintroducing building depreciation at a 1% rate is estimated to decrease the marginal effective tax rate for inbound foreign investment on industrial buildings from 44.3% to 39.9% and on commercial buildings from 41.5% to 37.2%.

22. These measures would help to offset any negative economic effects arising from an extension of capital gains taxation. They could also support the rebalancing of the economy by reducing the taxation of productive assets relative to the taxation of speculative investments in land.
23. Packages 1 and 3 focus more on personal tax reductions and savings measures. As a result, these packages are less supportive of productivity than packages 2 and 4 and do less to mitigate the potential negative impacts of taxing more capital gains.

## Efficiency (financial and physical capital)

21. Packages 2 and 4 are more focused on financial and physical capital and include efficiency- and productivity-enhancing measures that would

Figure 8.1: Benefit for individuals from personal income tax reductions



Source: Inland Revenue

## Housing affordability (financial and physical capital, social capital)

24. All four of the packages reduce personal income taxes. These reductions could help to compensate lower-income households if rents increase as a result of extending capital gains taxation. The Accommodation Supplement (which is automatically linked to housing costs) would also provide a buffer to help mitigate any potential increase in rents for lower-income households. The fiscal cost of this has not been included in these packages.
25. Packages 2 and 4 also include measures that may improve housing supply by allowing the owners of multi-unit residential properties to claim deductions for depreciation and removal of residential rental loss ring-fencing.

## KiwiSaver (financial and physical capital, social capital)

26. All four packages provide personal tax reductions and savings measures that are targeted at low-income KiwiSavers. All four packages reduce taxes on low-income KiwiSavers.

**Table 8.3: Tax cost/benefit for KiwiSavers from packages, including effect of taxing more capital gains**

Package	Net tax cost/benefit for KiwiSavers earning (2021-22)		
	\$0-\$48,000	\$48,000-\$70,000	\$70,000+
Package 1 – Personal income tax reduction focus	\$238m benefit	\$7m benefit	\$43m cost
Package 2 – Business and housing focus	\$238m benefit	\$7m benefit	\$43m cost
Package 3 – Savings focus	\$465m benefit	\$233m benefit	\$90m benefit
Package 4 – Diversified focus	\$238m benefit	\$103m benefit	\$43m cost

Estimates are preliminary and indicative.

Source: Secretariat for the Tax Working Group

## Living standards framework assessment

27. The packages mainly affect wellbeing through their impacts on New Zealand's social capital and financial and physical capital. All four packages are likely to increase social capital through improving horizontal equity and the integrity of the tax system. The four packages are also likely to improve the progressivity of the tax system. However, the degree of progressivity differs by package, with packages 1 and 3 having a greater focus on progressivity-enhancing measures.
28. Packages 2 and 4 are likely to deliver greater benefits for financial and physical capital through business measures to enhance productivity and efficiency. However, the net impact on financial and physical capital is ambiguous for all packages, given the uncertain impacts of taxing capital gains on productivity.
29. The direct impact on human capital of all the packages is likely to be smaller. Personal income tax reductions can improve incentives to work, and influence incentives to improve human capital, for example, by investing in training and education. However the net effects on these incentives are unlikely to be large compared with the effects on social, physical and financial capital.
30. The Group recommends a complementary set of measures to support natural capital in Chapter 4 *Environmental and ecological outcomes*. As previously noted, much of the potential revenue from environmental taxes is beyond the five-year window for the packages considered in this chapter. Further, the Group supports recycling some or all of the revenue from environmental taxation into measures that would support a transition to a more environmentally sustainable economy.

## Summary assessment

31. The four packages outlined in this chapter illustrate the range of options available to the Government if it decides to extend the taxation of capital gains. The best use of this revenue, however, will ultimately depend on the Government's priorities. Tax reform is only one

choice; the Government also has a wider set of options to consider beyond the tax system. The Group recommends that the Government assess the options for tax reform against other needs and priorities to determine what would best enhance the wellbeing of New Zealanders.

# 9

## Other opportunities to improve the tax system

1. In the *Interim Report*, the Group made recommendations covering a broad range of tax issues. In the preceding chapters of this report, the Group has only revisited some of these issues. Time constraints have precluded further in-depth investigation of the other issues but the recommendations remain an essential part of the Group's prescription for reform.
2. This chapter revisits recommendations relating to these other issues and provides links to supporting analysis in the *Interim Report*.
3. On some issues, the Group has revised or added to its recommendations. This was often in response to suggestions raised during public consultation on the *Interim Report*.
4. These recommendations should be read as opportunities to improve the tax system, not detailed proposals. The Group recommends that these measures be progressed as part of the Government's Tax Policy Work Programme and subject to the Generic Tax Policy Process.

### Matters requiring significant attention

5. The Group wishes to highlight several issues for particular attention by the Government. These issues pose significant risks to revenue collection and the administration and credibility of the tax system.

### The future of work

For supporting commentary, see Chapter 13 of the Group's Interim Report, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report.html#section-18>

6. The world is living through a period of intense innovation: digital technology is transforming established business models and altering traditional relationships between business and workers. As with other sectors of the economy, technology has the potential to disrupt existing paradigms in taxation, too. Combined with globalisation, generational demographics and climate change, there may be significant challenges for our workforce in the future.

### Challenges to the PAYE system

7. Most income tax is collected through the PAYE system. PAYE – or 'pay as you earn' – is a withholding system in which employers are responsible for deducting and paying income tax on their employees' behalf. PAYE has served New Zealand extremely well but its effectiveness will reduce if labour market changes increase the proportion of self-employed workers in the future.

8. The Group supports Inland Revenue's efforts to increase the compliance of the self-employed. The Group particularly supports an expansion in the use of withholding taxes to increase compliance and recommends that withholding be extended as far as practicable (including to platform service providers, such as ride-sharing companies). This should include making better use of technology platforms to deal with contractors' tax obligations.<sup>43</sup> The Group also recommends that Inland Revenue continue to use data analytics and information matching to identify taxpayers who are under-reporting income.

## Rules and definitions

9. The Group has identified two areas where a review of existing rules and definitions is necessary. First, the Group recommends a review of the existing GST treatment of contractors, as the current approach appears to impose compliance costs for little net tax collected.
10. Secondly, it has also become apparent to the Group that there is a risk of quite different definitions of employment status, including particularly 'employee' and 'dependent contractor' being used across Government. The Group recommends that the Government seek, where possible, to align these definitions for tax and employment purposes.

## Childcare costs

11. The Group has discussed support for childcare costs to increase participation in the workforce but considers this support is best delivered outside of the tax system.

## The integrity of the tax system

For supporting commentary, see Chapter 15 of the Group's *Interim Report*, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report-html#section-20>

12. Most New Zealanders recognise the importance of paying tax and meet their tax obligations. Some, however, do not. Tax avoidance reduces the integrity of the tax system and erodes social capital. It is also fundamentally unfair, because it means that compliant taxpayers must pay more to make up for the lost revenue.
13. A number of integrity risks have been addressed over the years. For example, the alignment of the trustee rate and the top personal income rate has greatly reduced the use of trusts to shelter income and avoid tax. Nevertheless, the Group has identified a number of areas where further action is required.

## The hidden economy

14. There are many ways to describe the hidden economy: it has been called the cash economy, the informal economy, the shadow economy and the underground economy. The hidden economy arises because some taxpayers decide to hide some or all of their income. These actions – which can often seem innocuous to the participants – have a corrosive effect on the tax system.

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<sup>43</sup> One example of this is 'smart accounts', where tax is automatically deducted and paid to Inland Revenue.

15. The Group commends the measures proposed under Inland Revenue's *Business Transformation* process for the increased use of data matching and analytics. It also recommends further measures to reduce the extent of the hidden economy (i.e. undeclared and cash-in-hand transactions). These measures could include an increase in the reporting of labour income and even the removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules. The Group also recommends that the Government review recent Australian initiatives to address the hidden economy, with a view to applying them in New Zealand.

## Collection

16. The Group recommends the use of departure prohibition orders in cases of deliberate or persistent non-payment of GST and PAYE by a company whose directors (or their associates) are the main economic owners of the business.
17. Such cases also justify a lowering of the corporate veil. The Group therefore recommends the introduction of a regime similar in design to Australia's Director Penalty Notice. As in Australia, a warning system would go hand in hand with the regime. If the pattern of non-payment of GST and PAYE continues, despite clear warning, it is appropriate to make directors who have an economic ownership in the company personally liable for GST and PAYE. Defences similar to those in Australia – such as illness, taking reasonable steps to ensure payment and the like – would be available to directors under this regime.
18. Aligning the standard of proof for GST and PAYE offences would also encourage compliance.
19. The Group recommends the establishment of a single Crown debt collection agency, with (as far as possible) consistent rules for treatment of debtors, to achieve economies of scale and more equitable outcomes across all Crown debtors.

## Closely held companies

20. The Group is aware of a number of tax integrity concerns relating to closely held companies. Some of the underlying problems derive from the fact that the company and top personal tax rates are not aligned but there is a clear need for Inland Revenue to strengthen enforcement of the rules for closely held companies. The Group also recommends that the Government explore options to enable the flexibility of a wider gap between the company and top personal tax rates without a reduction in the integrity of the tax system.
21. The Group recommends that Inland Revenue should have the ability to require a shareholder to provide security to Inland Revenue if: (i) the company owes a debt to Inland Revenue; (ii) the company is owed a debt by the shareholder; and (iii) there is doubt as to the ability and/or the intention of the shareholder to repay the debt.

## Trusts

22. With the alignment of the trustee rate and the personal income rate, the trust tax rules are basically sound. Many of the remaining challenges associated with trusts relate to deeper issues in the tax system, such as the inconsistent taxation of capital income and should be considered within that context.
23. The one discrete issue that may need attention relates to trading in trust losses. The Group recommends that the Government consider this issue if the general anti-avoidance rule is insufficient, potentially in tandem with a review of the loss-continuity rules for companies.

## Tax technical capability

24. The integrity issues identified in this report and ones identified in the past, have all come from the work of technically skilled investigators. No matter how good the tax policy and tax administration systems are, tax investigation is a complicated task. The Group recommends that Inland Revenue continue to invest in the technical and investigatory skills of its staff.

## The administration of the tax system

For supporting commentary, see Chapter 17 of the Group's Interim Report, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report-html#section-22>

25. Tax policy is given effect, day in and day out, through the administration of the tax system. The quality of administration is central to public perceptions of the legitimacy and fairness of tax policy; the effectiveness of administration will determine the Government's ability to achieve its policy intent in levying taxation.

### Tax secrecy and tax transparency

26. Tax secrecy is a topical issue in tax administration at the moment. The Group recommends that the Government release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available). The Government could consider further measures to increase transparency as public attitudes change over time.

27. The Group also recognises there is a need for good quality data for both the public and the Government to understand the current functioning of the tax system, and to provide the basis for advice when further changes are contemplated in the future.

28. Areas of likely need include data on the distribution of income, wealth and taxation, effective tax rates, international taxation, the finance sector, different sources of income, and compliance. The Group recommends that the Government build the ability of its agencies, including Inland Revenue and Stats NZ, to provide such information and make it available

to the public for information and research purposes. This would be assisted by interagency collaboration with MBIE to increase transparency regarding the beneficial ownership of companies and limited partnerships.

29. To better understand the profile of capital income, wealth and its owners in New Zealand, the Group recommends that the Government:
- fund an oversampling of this group in existing wealth surveys
  - include a question on wealth in the Census
  - request Inland Revenue to regularly repeat its analysis of the tax paid by high-wealth individuals (Inland Revenue, 2016)
  - commission research, using a variety of sources of data on capital income (including administrative data) to estimate the wealth of individuals.
30. As part of the Government's efforts to build a more sustainable economy, the Group encourages Inland Revenue to collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.

### Tax disputes

31. The Group also recognises there is a need to improve the resolution of tax disputes. The Group recommends the establishment of a taxpayer advocacy service to assist taxpayers in disputes with Inland Revenue and also recommends that the Office of the Ombudsman be adequately resourced to carry out its functions in relation to tax.
32. Following the introduction of a taxpayer advocacy service, the Group recommends that the Government design a truncated tax dispute process for small taxpayers.

## The development of tax policy

33. The Group has discussed opportunities to improve the development of tax policy and legislation. In particular, it is important to include a more diverse range of voices in the development of tax policy. To achieve this outcome, the Group recommends the use of the following principles to guide public engagement on tax policy:

- Good faith engagement by all participants.
- Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Māori/Crown Relations).
- Earlier and more frequent engagement.
- The use of a greater variety of engagement methods.
- Greater transparency and accountability on the part of the Government.

34. The Group has noted the need for the Treasury to play a strong role in tax policy development and for Inland Revenue to maintain deep technical expertise and strategic policy capability, including greater strength in environmental issues and a Te Ao Māori perspective.

## Legislative frameworks

35. The Group encourages the continuing use of purpose clauses in legislation, where appropriate, and recommends the inclusion of an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.

36. This overriding clause could explain that the legislation specifies the:

- rules for effective and efficient administration and collection of tax revenues so the Government can improve the wellbeing of New Zealanders
- rights and obligations of taxpayers
- rights and obligations of Inland Revenue.

## Matters requiring further work

The Group wishes to highlight the following issues for further work by the Government.

## Charities

For supporting commentary, see Chapter 16 of the Group's *Interim Report*, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report-html#section-21>

37. Charities and non-profit organisations make important contributions to the wellbeing of New Zealand. The activities of these organisations enhance the social, human and natural capital of New Zealand. In turn, the Government supports the work of charities by offering tax exemptions for charity income and tax benefits for donations to charities.

## Business income, accumulation and distribution

38. The Group received many submissions regarding the treatment of business income for charities and whether the tax exemption for charitable business income confers an unfair advantage on the trading operations of charities.

39. The Group considers that the underlying issue is more about the extent to which charities are distributing or applying the surpluses from their activities for the benefit of the charitable purpose. If a charitable business regularly distributes its funds to its head charity, or provides services connected with its charitable purposes, it will not accumulate capital faster than a taxpaying business.

40. The question, then, is whether the broader policy settings for charities are encouraging appropriate levels of distribution. The Group recommends the Government periodically review the charitable sector's use of what would otherwise be tax revenue, to verify that the intended social outcomes are actually being achieved.

41. In this regard, the Group notes that other countries, such as Canada, have introduced regimes where all registered charities are required to spend a minimum amount each year on their own charitable activities or on gifts to qualified donees (for example, other charities).

### Private charitable foundations and trusts

42. The Group is concerned about the treatment of private charitable foundations and trusts. These foundations and trusts benefit from the donor tax concessions but are not required to have arm's-length governance boards or distribution policies. The rules around these foundations and trusts appear to be unusually loose.
43. The Group recommends that the Government consider whether to apply a distinction between privately controlled foundations and other charitable organisations and removing concessions for privately controlled foundations or trusts that do not have arm's-length governance or distribution policies.

### Other rules

44. The Group considers that the charity deregistration tax rules could be amended to more effectively keep assets in the sector and also questions whether the current GST concessions for non-profit bodies are appropriate.
45. The Government has launched a review of the Charities Act 2005 to ensure it remains effective and fit for purpose. The Group has provided its analysis to Inland Revenue and the Department of Internal Affairs for further consideration as part of the Charities Review and the Tax Policy Work Programme.

## GST and financial transaction taxes

For supporting commentary, see Chapter 12 of the Group's *Interim Report*, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report-html#section-17>

46. GST has proven to be a stable and efficient tax base and is a major source of revenue for the Government. The Group acknowledges public concerns about the regressive nature of GST but has decided not to recommend a reduction in the GST rate or the introduction of new GST exceptions (for example, for food and drink).
47. This is because there are more effective ways to increase progressivity than a reduction in the rate of GST. Increases in welfare transfers would have a greater impact on low-income households. Changes to personal income tax can also have a greater impact on low- and middle-income earners. GST exceptions are complex, poorly targeted for achieving distributional goals and generate significant compliance costs. Furthermore, it is not clear whether the benefit of specific GST exceptions are passed on to consumers.
48. Further, if GST is removed from one good or service, it becomes difficult to argue against further exceptions on similar grounds. Increasing numbers of exceptions will erode the GST base and require tax increases elsewhere to make up the lost revenue.
49. The Group also notes that maintaining a GST rate of 15% ensures that this tax is collected from people who would not otherwise be in the tax base, such as tourists.

## The treatment of financial services

50. One other problematic aspect of GST relates to the treatment of financial services. Financial services are not subject to GST for reasons of administrative complexity. There is a strong in-principle case to apply GST to financial services but the Group has not been able to identify a means of doing so that is both feasible and efficient. The Government should monitor international developments in this area.

## Low-value imported goods

51. The Group has already reported to Ministers on the issue of GST on low-value imported goods and the Government is advancing this work.

## Financial transactions taxes

52. The Group recognises there is active international debate on financial transaction taxes, which should be monitored. However, it does not recommend the introduction of a financial transactions tax at this point.

## Corrective taxes

For supporting commentary, see Chapter 10 of the Group's *Interim Report*, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report-html#section-15>

53. A corrective tax is a type of tax that is primarily intended to change behaviour and lead to better health and wellbeing outcomes for New Zealanders.<sup>44</sup> Outside of the environmental sphere, New Zealand currently levies corrective taxes on the consumption of alcohol and tobacco.

54. Some submitters have suggested the development of a framework for deciding when to apply corrective taxes (similar to the framework developed by the Group for the use of environmental taxes). The Group supports this suggestion.

## Alcohol and tobacco excise

55. Detailed recommendations on the rates of alcohol and tobacco excise are beyond the expertise of the Group. However, the Group does recommend the Government simplify the schedule of alcohol excise rates and is concerned about the distributional impact of further increases in tobacco excise beyond the increases that have already been scheduled.

56. The Group's preference is that, once the current schedule of tobacco excise increases end, the Government prioritise other measures to help people stop smoking before it considers further large increases in tobacco excises. Some of the revenue from tobacco excise could also be directed towards smoking-cessation programmes.

## Sugar taxes

57. The Group acknowledges widespread public interest in the adoption of a sugar tax. The case for a sugar tax must rest on a clear view of the Government's objectives. If the Government wishes to reduce the consumption of sugar across the board, a sugar tax is likely to be an effective response. If the Government wishes to reduce the sugar content of particular products, regulation is likely to be more effective. In either case, there is a need to consider the use of taxation alongside other potential policy responses.

58. The Group has provided the relevant agencies with its work on these issues.

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44 Some submitters have suggested that the Group use the terms 'health-promoting taxes' or 'behavioural-enhancing taxes' instead of 'corrective taxes'. While acknowledging that these taxes can be used to promote health or enhance behaviour, the Group prefers to use the term 'corrective taxes', as it is generally understood in the field of tax policy.

## Housing

For supporting commentary, see Chapter 8 of the Group's *Interim Report*, which is available at: <https://taxworkinggroup.govt.nz/resources/future-tax-interim-report-html#section-13>

59. Housing affordability is one of the key issues for consideration by the Group. The Terms of Reference direct the Group to have special regard to housing affordability, as well as to consider whether housing tax measures would improve the tax system. The Group's work on housing affordability is closely linked with its work on the taxation of capital income.
60. Since the *Interim Report*, the Group has given further consideration to a tax on vacant residential land, or on empty homes in residential areas, to encourage the use of existing urban areas. There are international examples that could inform the development of similar taxes in New Zealand.
61. These types of taxes would appear to be most feasible in cases where a local authority has rezoned the land and provided infrastructure but the land remains vacant. The Group recommends that the Productivity Commission include these taxes within its review of local government funding and financing. The main risk with these taxes is that they encourage the token (rather than substantive) use of land or homes.
62. The Group's view is that such taxes are best levied at the local rather than the national level. Any new housing spurred on by these taxes would also need to occur on a planned and environmentally sustainable basis.

# Appendix A: Assumptions in projected revenue for extending the taxation of capital gains

## Assumption: Growth rate

1. The value of residential investment property is assumed to grow at a 3% nominal annual rate (2% inflation plus 1% real growth rate). That rate is also used for other categories of real property.
2. New Zealand shares are assumed to appreciate at 3% per year.<sup>45</sup>

## Assumption: Size of base

3. Table A.1 shows how initial values (from 1 April 2021) were derived from the most recently available data. Prices are assumed to increase at a rate of 3% per year until 1 April 2021. In addition, the base for residential rental property, second homes and commercial and industrial property are assumed to increase by an additional 2.8% to reflect additional building investment.

4. For managed fund assets the total value of shareholdings are projected to grow at 5% per annum.

## Assumption: Turnover rate

5. The costings are on a realisation basis for all assets not held by managed funds. For real property, holding periods are taken from Corelogic data for property sold from 2008-2018. The average holding period using this data is:
  - residential investment property: 8.4 years
  - commercial and industrial property: 8.7 years
  - agricultural property: 9 years.
6. New Zealand shares are assumed to have an average turnover rate of 33% (based on data from World Federation of Exchanges).

Table A.1

Base	Data source	Observation date	Value at observation date \$b	Grossed-up value at 1 April 2021 \$b
Residential rental property	Reserve Bank Household Balance Sheet	March 2018	272	323
Second homes <sup>46</sup>	Household Economic Survey	September 2014	30	50
Commercial, industrial and other property	Corelogic	October 2017	217	264
Rural	Corelogic	October 2017	181	190
Domestic listed shares not held by managed funds	Household Balance Sheet	June 2018	121	132
Domestic listed shares held by managed funds	Reserve Bank Managed Fund Assets	September 2018	10	12

<sup>45</sup> NZX capital index information shows New Zealand shares appreciated by 3.7% per year, on average, from 1990-2017.

<sup>46</sup> The values for second homes have been uplifted by historical appreciation rates from 2014-2018. From 2018 onwards the uplift is based on an assumed 3% price appreciation and 2.8% new investment.

### Assumption: Lock-in effect

7. The costings assume that extending the taxation of capital gains will cause behavioural changes through a 'lock-in effect'. The costings assume that the average holding period will increase by 10% as a result of this lock-in effect.<sup>47</sup>

### Assumption: Rollover relief

8. The costing incorporates rollover relief recommendations made by the Group. The assumptions regarding these rollovers are based on the following in Table A.2.

### Assumption: Average marginal tax rate

9. The assumed average marginal tax rates for each property category:<sup>48</sup>

- Residential rental property and second homes: 26%.
- Commercial, industrial and other property: 25%.
- Rural property: 25%.

- Domestic listed shares not held by managed funds: 28%.
- Domestic shares held by managed funds: 25%.

10. The average tax rate for rural, commercial, industrial and other land is assumed to be 1 percentage point lower as a result of allowing small businesses sold in retirement to utilise PIE tax rates.

### Risks: Risks that the projected revenue could be understated

11. **Unknown parts of the base** – The projected base uses elements of the base that are known through published statistics – values of real property and New Zealand shares. Some elements of the base are not known and so are not costed. These include shares in Australian listed companies, shares in private companies and intangible property such as goodwill, brands, trademarks and intellectual property.

Table A.2:

Proposal	Property it affects	Proportion of realisations covered by rollover relief	Source
Replacement active assets held by small businesses (turnover <\$5m)	Rural, commercial, industrial and 'other' land	34% of rural, commercial, industrial and 'other' land sales	Annual enterprise survey and Linked Employer-Employee Dataset. Based on proportion of: <ul style="list-style-type: none"> <li>• fixed assets held by businesses in sales threshold</li> <li>• non-residential land held passively</li> <li>• self-employed that appear to be retiring.</li> </ul>
Inherited property, relationship property and insurance	All assets costed	10% for land 5% for shares	For inherited land, rollover assumption based on proportion of land transfers that were made to an executor in 2018.  For relationship property and shares acquired through an inheritance, rollover assumption estimated using methodology in (Briggs, 2008). Insurance rollover based on value of insurance proceeds for commercial damage.

47 This 10% is based on the difference in average holding periods between New Zealand and Australia.

48 The average tax rates for real property are based on the average tax rates for small and medium enterprises in New Zealand that earned untaxed realised gains. These are increased slightly to account for large enterprises that are likely to be on the 28% rate.

## Risks: Risks that the forecast revenue could be overstated

12. **Overlap with current revenue account property** – Some property is already subject to tax on gain when sold (revenue account property). The most significant of these are real property sold by developers and dealers. This is not adjusted for owing to lack of information. This also includes property subject to the bright-line rule and taxable under the intention test.
13. **Compliance with rules** – The costing assumes full compliance with the rules for extending the taxation of capital gains. Revenue may be lower as a result of non-compliance.

## Risks: Risks that could either overstate or understate the forecast

14. **Variation from assumptions** – actual conditions may vary from what is assumed. In particular, the actual appreciation rate is likely to vary over

time and be both above and below the assumed growth rate at times. Other factors, such as size of the base and turnover rates, could also vary from the assumptions. The impact of rollover reliefs are difficult to estimate as there is a lack of data regarding who would be able to utilise reliefs.

15. The impact of any variations of assumptions is significant. Small changes in the main assumptions can lead to significant changes in the revenue projections. As a result the projected revenue should be considered as indicative and subject to considerable uncertainty.
16. In addition, revenue from taxing capital gains is likely to be volatile and be greater when there is asset price growth and decline when asset prices fall.
17. Revenue estimates for the taxation of capital gains are done for capital gains earned during tax years. Revenue estimates may change when accruing revenue to specific fiscal years.



# Appendix B:

## Summary of consultation and submissions

The Group received over 600 submissions on its *Interim Report*.<sup>49</sup> The Group considered the submissions as part of its decision-making process and is grateful for the time and effort that people put into submissions. The main topics submitted on were an extension to the taxation of capital gains, environmental and ecological outcomes, retirement savings and personal income. The high-level themes of submissions on these topics are outlined below.

The Group also undertook some targeted consultation on the implications of the proposals and ideas raised in the *Interim Report*. This included Māori engagement and consultation on environmental and ecological issues. The Group is grateful for the invitations members received to discuss matters raised in the *Interim Report*. Regretfully, the Group was not able to meet with all interested submitters.

### Extension to the taxation of capital gains

Following the release of the Group's *Interim Report*, the Group consulted widely with expert stakeholders on the topic of an extension to the taxation of capital gains. This included meetings with key tax policy stakeholders, such as Chartered Accountants Australia and New Zealand and the Corporate Taxpayers Group. The Group consulted with Australian experts that spoke to the nature of Australia's capital gains tax regime and the

implications for New Zealand. The Group also received many submissions about an extension to the taxation of capital gains. A summary of the key design elements that were raised most frequently by submitters is outlined below.

### Excluded home

In its Terms of Reference, the Group was asked to exclude the family home and the land under it from the design of any extension of the taxation of capital gains. Twenty-six submissions commented on the topic of the family home exclusion.

Most submitters who commented on this topic supported excluding the family home. However, a number of submitters raised concerns that such an exclusion could lead to a 'mansion effect', whereby homeowners would improve their houses, rather than investing in other forms of savings, to get a tax-free return. Some submitters considered this could be addressed to some extent by putting a cap on the value of the property that was excluded from the tax.

Some submitters considered that private-use second homes (e.g. baches) should be exempt from any tax on capital gains. This was on the basis that they are personal property in the same way that owner-occupied housing is, rather than income-producing assets. Some submitters considered that modest rural lifestyle blocks that exceeded 4,500m<sup>2</sup> should be exempt and it was also argued that the 4,500m<sup>2</sup> limitation could create compliance difficulties for the farming community.

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<sup>49</sup> Submissions formally closed on 1 November 2018. Six hundred and eighteen submissions were received by 12 November 2018 and form the basis of this analysis.

Other aspects of the excluded home topic that were commented on included:

- ownership of homes by trusts or jointly with extended family
- situations where the family owns more than one home (or owns one house but lives elsewhere for work reasons)
- ensuring that interests held via flat-owning companies would be entitled to the excluded home rule, and
- ensuring that the design of the excluded home rule would not hinder people from borrowing against their property to fund their retirement ('reverse mortgages').

## Valuation Day and compliance costs

Ten submitters specifically commented on the 'Valuation Day' approach preferred by the Tax Working Group in the *Interim Report*. All of these submitters were either opposed to or expressed concern with this approach, specifically owing to the high compliance cost and uncertainty associated with ascertaining the value of assets for their entry into the tax base. In particular, submitters thought that obtaining business valuations would be difficult, the market may not have the capacity to carry out the number of valuations required and that disputes over the estimated values may arise. Submitters emphasised the need for low compliance cost methods for determining an asset's value and stressed that 'near enough' is 'good enough' to help manage compliance costs. The preferred alternative to a 'Valuation Day' approach was the approach taken in Australia where the rules applied to all assets acquired after the commencement date.

In addition to the initial costs associated with a Valuation Day approach, a number of submissions also commented more generally on the compliance costs from extending the taxation of capital gains. Submitters were concerned that the tax would require many complex rules and that compliance costs may be high relative to the additional revenue that the tax would raise.

## Rollover and loss ring-fencing

22 submitters made submissions on rollover. Most advocated for specific forms of rollover but several also pointed out that rollover creates complexity and emphasised the importance of a clear framework to ensure it is coherent. Several submitters supported rollover for sales of business assets followed by reinvestment but did not always make clear whether they supported requiring the reinvestment to be in a replacement asset. Some submitters supported rollover for business reorganisations with no change in ownership in substance. Some submitters supported rollover on death in some form. Some submitters also supported rollover that accounts for the way that Māori assets are held collectively and passed down from generations. The few submitters that commented on involuntary disposals (e.g. forced sales and separations) supported rollover relief for such situations. Only one submitter was generally opposed to rollover that allowed tax liability to be deferred indefinitely even where assets had changed hands.

Nine submitters spoke to general ring-fencing of capital losses with a majority opposed. Some of these submitters queried whether concerns about taxpayers cherry-picking losses and deferring gains could be better addressed by other means, such as targeted anti-avoidance rules or requiring losses to be offset against rolled over gains first before being available to offset other income. A few submissions also opposed, or asked the Government to reconsider, rental loss ring-fencing.

## Shares

There were 15 submissions to the *Interim Report* that focused on how extending the taxation of capital gains would apply to shares. Issues raised in these submissions included:

- The extension should not apply to New Zealand and listed Australian shares. It was argued that taxing these would discourage investment in such assets, particularly if there was no change to the taxation of other shares (i.e. if the fair dividend rate continues to apply).

- Any changes to the taxation of shares has to apply both to direct investment and funds, to preserve neutrality.
- If Australasian shares are taxed, for funds, the taxation should be on an accrual basis, with a discount to recognise the time value of money.
- Listed portfolio investment entity (PIE) treatment for share-owning listed PIEs should be replaced by an extension of the multi rate PIE regime, though this would require updated registry systems.
- If shares are taxed, this should be on an RFRM basis.
- Double taxation issues raised by taxing both companies and shares in companies are real and need to be addressed. They could be solved by taxing only at the investor level, or the company level.
- The effect of taxing sales of shares on corporate groups needs to be considered. The Australian single economic entity approach was not supported.
- Taxing shares is double taxation because the shares have often been acquired using tax paid income.

## Building depreciation and seismic strengthening

All 10 submitters who commented on building depreciation supported reinstating depreciation. Some submitters commented that building depreciation should be reinstated regardless of the decisions reached on extending the taxation of capital gains and one submitter supported raising the corporate tax rate to fund the fiscal cost if required. There was generally more support for depreciation on commercial and industrial buildings than on residential buildings and for the proposal to reinstate depreciation for multi-unit residential buildings but not standalone residential buildings. One submitter considered that the current position allowing the Commissioner to set provisional rates for buildings with an expected useful life of less than 50 years was not working adequately. Several submitters acknowledged the large fiscal cost of reinstating building depreciation and were generally supportive of a phased reintroduction. Few submitters commented on the depreciation rate, though the ones that did supported the previous rates of 2% straight-line or 3% diminishing value.

Eight submitters agreed with the Group's comment in the *Interim Report* that the current tax treatment of seismic strengthening is counterintuitive (namely that a deduction is allowed if a building collapses but deductions cannot be claimed in respect of expenditure to strengthen a building). They noted that there is a large public benefit gained from seismic strengthening. These submitters wanted the Group to recommend a change to the current treatment, whether that was a deduction or an ability to depreciate. One submitted that any change should be retrospective so that taxpayers who have already strengthened their buildings are not disadvantaged. Another submitted that the tax treatment should not distinguish between residential owner occupiers and other taxpayers (e.g. investors, landlords, commercial building owners).

## Risk-free rate of return method (RFRM)

The Group received 27 submissions following the *Interim Report* on the topic of the risk-free rate of return method. These submissions were generally negative. In particular, submitters highlighted the following issues:

- the lack of cash flow to pay the tax
- the requirement for up-to-date valuations
- the perception that it encourages people to take on debt to reduce equity
- that the tax could vary based on interest rates over time
- the perception that it could discourage improvements which previously that have received a tax deduction
- that it may result in sale of assets by Māori organisations to meet tax liabilities as a number of settlement assets are locked into low yields as part of the settlement process
- that it would inappropriately tax land that is used for public purposes (even if privately owned) and is not generating income.

Some submitters favoured the simplicity of the tax and thought it provided greater certainty than a realisation-based capital gains tax and that it would lead to fewer disputes.

## Environmental and ecological outcomes

Consultation on environmental tax issues occurred through three avenues: focus groups made up of primarily representatives from environmental interest groups who had made earlier submissions to the Group; industry meetings with representatives from energy and agriculture sectors; and written feedback from participants in either the focus groups or industry meetings. In addition, the Group received 459 submissions (including 430 standard form submissions based on a New Zealand Taxpayers' Union template) that commented on environmental tax issues in the *Interim Report*.

A diversity of views was expressed in consultation. Overall, feedback was generally supportive of the frameworks, although there were a range of proposed changes. A common message from environmental interest groups was that the report did not go far enough to acknowledge New Zealand's pressing environmental problems and the urgency of action. Industry representatives raised a number of concerns, including about how taxes would practically work and their efficacy for addressing particular environmental problems.

Submissions were generally supportive of the Group's focus on environmental issues and the potential for environmental taxes to play a greater role in the tax base. Most submitters were supportive of the Group's suggested frameworks for when to use environmental taxes, although some submitters suggested additional design principles and criteria, or raised concerns about consistency with other tax policy principles. There were mixed views on hypothecation of environmental tax revenues – most submitters supported the Group's recommendation in the *Interim Report* to ring-fence revenue for environmental purposes, while a minority were opposed. Several submitters raised industry-specific concerns about the adverse impacts of particular taxes, especially relating to hydroelectric generation and agriculture. There were calls for the Group to give greater consideration to the broader impacts of the tax system on natural capital. There was also significant opposition (the vast majority from submissions based

on a New Zealand Taxpayers' Union template) to the Group's recommended changes to the emissions trading scheme and the waste disposal levy on the basis of their impact on households and the lack of an objective framework accounting for both costs and benefits.

## Engagement with Māori

In October 2018 the Tax Working Group carried out engagement hui with Māori in five locations around New Zealand. The objectives of this process were to ensure that the recommendations and ideas raised in the *Interim Report* were well understood by Māori organisations and to collect feedback to inform further advice.

In relation to the Māori authority regime, participants expressed support for the Group's recommendation to extend the 17.5% tax rate to wholly-owned subsidiaries of Māori authorities.

A number of issues were raised concerning extending the taxation of capital gains. While there was generally support for making the tax system fairer, there was concern that in practice it may generate more inequities. A key area of discussion was around how principles of rollover might apply to the acquisition of ancestral land by collectively owned Māori organisations and the reorganisation of assets within iwi or other Māori entities. Participants also spoke about the difficulties associated with attracting capital to develop Māori Freehold Land, as well as the legislative and practical issues that arise from owning such land collectively.

With regards to He Ara Waiora and the development of a Te Ao Māori framework for tax policy, participants were generally supportive of the intent but signalled clearly the risks of tokenism and were interested in seeing more work on how the framework could have practical application. Following the hui, Sacha McMeeking (Head of Māori Studies, University of Canterbury) presented a consolidated response from the Māori engagement process to the Group, supporting the direction of the work and recommending that He Ara Waiora be taken forward by the Treasury in the context of the Living Standards Framework.

A range of other issues were also raised. There was widespread interest in seeing efforts to preserve and develop natural ecosystems recognised, for example, through biodiversity tax credits. There was considerable discussion on charities and interest from Māori in the Department of Internal Affairs' review of the Charities Act 2005. Participants expressing a desire for greater recognition for the extensive amount of unpaid work done by Māori was also a theme of discussions.

## Retirement savings

The Group received thirty-four submissions on the topic of retirement savings. Submitters who commented on the issue of retirement savings had a mixed view of the recommendations in the *Interim Report*. While there was general support for the Group's position, some submitters believed that the Group had not adequately made the case for retirement saving tax incentives. Further, most submitters who supported the Group's retirement savings proposals advised that the proposals should be applied more broadly, rather than being restricted to KiwiSaver.

In particular, it was argued that the Group's proposal to reduce the lower PIE tax rates for KiwiSaver funds should be extended to all PIEs. It was argued that this would avoid distortions and prevent practical issues from arising for KiwiSaver scheme providers that also offer other PIE products to investors. In light of the Group's equity objectives, some submitters also recommended raising the top PIE tax rate to 33% to align it with the top personal income tax rate and the trust tax rate.

Many submitters also had a view on the Group's proposal to provide an employer's superannuation contribution tax (ESCT) exemption for amounts paid to individuals earning up to \$48,000 per year. It was argued that this proposal could be complicated to administer for employers because they would not necessarily be aware of an employee's income other than employment income (and they may also have income from a second job). Instead, it was suggested by some submitters that Inland Revenue is better placed to provide a credit for ESCT once it is verified that an individual has total income under the recommended \$48,000 threshold. Submitters also considered that an ESCT exemption should be

available for non-KiwiSaver retirement schemes, such as workplace savings schemes.

## Personal income

The Group received 465 submissions (including 437 standard form submissions based on a New Zealand Taxpayers' Union template) on the topic of personal income taxation. Submissions were generally positive, particularly in relation to reducing the income tax rates for lower- and middle-income earners. Some submitters thought that the Group should have considered a steeper progressive tax scale, particularly at the higher-income level. There was also significant support (the vast majority of which came from standard form submissions based on a New Zealand Taxpayers' Union template) for indexing of tax thresholds such that they are adjusted with changes in average earnings or inflation.

## Civil society engagement

Following the release of the *Interim Report*, members of the Group met with a number of representatives of the civil society sector. A broad range of tax issues were raised.

On extending the taxation of capital gains, some submitters thought that the family home and houses held in Trusts should not be exempt from tax. However, if family homes were to be exempt, submitters were supportive of the Group's suggestion to include an upper threshold of \$5 million.

On the environment, several submitters thought that the role of tax should be to incentivise behaviour change. This would mean that environment taxes would potentially collect almost no revenue if successful in changing behaviours. Some submitters disagreed with the Group's recommendation that the ETS should be 'tax-like'.

One submitter was supportive of the recommendation to review alcohol and tobacco excise structures. Concerns were raised that these taxes are aimed at changing behaviour, however, demand for the products are inelastic meaning behaviour doesn't change and only revenue is generated.

Concerns were raised about inconsistencies between the tax and the transfer systems, such as unit of assessment (i.e. household vs individual) and treatment of gifts.

Some submitters were concerned about aspects of the analysis in the *Interim Report*. The *Interim Report* includes analysis showing the higher deciles paying disproportionately higher levels of tax than other deciles. Some submitters viewed this analysis as incomplete, given these groups had both disproportionately higher levels of income and untaxed capital gains. There was also concern that income from capital gains was not part of the income in some distributional analyses.

There was support expressed for a range of measures, including a gift tax; a tourist tax (to address environmental concerns); the Group's recommendation for a centralised Crown debt collection agency; and for continuing work on a financial activities tax and the stabilisation role of the tax system.

## Corrective taxes

Members of the Group met with representatives of public health providers and researchers.

There was concern over the term 'corrective taxes' as their preferred term was 'health promoting taxes'. There was also concern with the use of the New Zealand Institute of Economic Research (NZIER) framework and a preference for development of a framework similar to the one developed for environmental and ecological taxation.

For tobacco there was concern that the Group was proposing that the current schedule of increases be stopped in preference for measures to help people stop smoking. There were mixed views on the Group's recommendation that the Government should consider other measures for tobacco control after the current schedule of increases end. Some submitters agreed with the Group's concern about the recessive nature of a tax on an addictive substance while others felt this concern was overplayed as compensatory measures were possible.

One submitter argued for any increase in tobacco excise to come in on 1 July rather than 1 January as there were no services available to help cease smoking in January.

For alcohol there was general support of the recommendation to review the excise structure. However, there was concern with a suggestion that the alcohol content be taxed on a linear volumetric basis. This was because it would make spirits relatively less expensive than wine and beer, changing the price signals we have now. An alternative proposal was for three bands of excise, a low band for low alcohol products, a wine and beer band, and a high band for spirits and ready-mix drinks. Overall, submitters wanted to see a 50% rise in excise rates, pointing to overseas evidence suggesting it would have a positive behavioural response and reduce harm.

## Other issues raised in submissions

In addition to the main topics that were submitted on and outlined above, submissions were also made on a number of other topics, including the following:

- housing affordability
- international tax
- GST and financial transactions taxes
- taxation of business
- integrity of the tax system
- charities, and
- administration of the tax system.

A large number of the submissions received by the Group were made with the use of a New Zealand Taxpayers' Union template. Submissions received with this template generally made the following points (other than those mentioned in relation to the topics above):

- There should not be any new tax on capital but if there is, that the revenue generated from such a policy is used to reduce other taxation.
- There should be a tax exemption for the inflation component of interest income.
- There should not be increases to tobacco excise or alcohol excise.
- There should not be a sugar tax.

# Appendix C:

## List of Secretariat and other advice

In the course of its consideration of the issues discussed in this report, the Group received advice papers from its Secretariat (a cross-agency group of officials mainly from the Treasury and Inland Revenue) and external officials. Some Group members also provided notes for the consideration of their colleagues. A list of that advice follows.

### Secretariat advice

#### Frameworks

- An introduction to frameworks for evaluating tax reform
- Tax Working Group assessment framework
- Tax and fairness

#### Extending the taxation of capital gains

- Extending the taxation of capital income
- Potential high-level effects of proposals to extend the taxation of capital income
- Distributional analysis and incidence of taxing capital gains
- The risk-free return method of taxation and land taxes
- Taxation of capital income and wealth
- Secretariat support papers on various capital gains tax design issues
  - Rollover relief
  - Transition, Valuation Day and the median rule

- Inflation and capital gains
- Agreed design features for extending the taxation of capital gains
- Risk-free return method of taxation
- Extending the taxation of capital gains: Rollover treatment
- Options for rollover and small business treatment
- Rollover treatment under an extension of the taxation of capital gains
- Extending the taxation of capital gains: Valuation Day
- Extending the taxation of capital gains: Managed funds and retirement savings
- Intangible assets under an extension of the taxation of capital income
- Implications for social policy of an extension of the taxation of capital income
- Fair rate of return method for rental property
- Domestic share issues with taxing capital gains
- International issues with taxing capital gains
- Compliance costs of taxing more capital gains
- Australian feedback on proposed design for taxation of capital gains
- Loss ring-fencing options for taxing capital gains
- Secretariat comment on the idea of exempting capital gains at the corporate level
- Estimated fiscal impact of a 2008-style share market crash on managed funds
- Treatment of expenditure on capital assets

## Housing

- Tax and housing – Paper I
- Tax and housing – Paper II
- Residential property compliance work
- Extending the taxation of capital gains in a supply-constrained housing market and phasing in implementation
- The excluded home for taxation of capital gains
- Taxing vacant property

## Environment

- Tax and the environment – Paper I: Frameworks
- Tax and the environment – Paper II: Assessments
- Environmental tax concessions raised by submitters
- Environment tax frameworks – finding of external reviewers
- Tax concessions and environmental impacts

## Business tax

- Business tax – Summary of papers
- Appendix 1: Types of business entities in New Zealand and how they are taxed
- Appendix 2: Company tax rate issues
- Appendix 3: New Zealand's imputation system
- Appendix 4: Closely held companies
- Appendix 5: Dividend avoidance
- Appendix 6: Measures to improve efficiency
- Appendix 7: Lower tax rates for small companies
- Company tax rate issues – further information
- Further information on marginal effective tax rates
- Effective company tax rates
- Company tax rate issues – Review of Secretariat modelling
- Taxing international business income
- Update on taxing the digital economy
- Effective company tax rates in New Zealand

## GST

- Background paper: GST
- GST and low-value imported goods
- Note on effect of decreasing the rate of GST
- Incidence of GST exemptions
- Taxing financial services

## Integrity

- Trusts
- Follow up on closely held company issues
- Preparing the tax system for the future
- Tax policy report: Estimating the under-reporting of income in the self-employed sector (IRD policy report on self-employed compliance)
- Hidden economy
- Dependent contractors
- The future of work
- Future of work: Sustaining the tax system
- Charities and the not-for-profit sector

## Tax administration

- Collection of tax debt
- The generic tax policy process
- Tax transparency
- Extending the taxation of capital gains: Administration implications
- Compliance cost savings for small and medium enterprises
- Information collection and dissemination by Inland Revenue
- Responding to Ministers on wealth, capital income and effective tax rates in the top decile

## Māori issues

- Tikanga framework (Draft)
- Māori authorities
- Extending of taxation of capital gains and Māori interface
- Extending the taxation of capital income: implications for Māori collectively-owned assets
- Understanding impacts for Māori and update on Te Ao Māori framework
- Māori collectively held assets and capital income

## Revenue-negative options

- Potential revenue-reducing options
- Appendix A: Productivity
- Appendix B: Changes to tax rates and thresholds
- Appendix C: Depreciation on Buildings
- Appendix D: Changes to loss-continuity rules
- Appendix E: Inflation indexing the tax system
- Appendix F: Compliance cost reductions
- Appendix G: Depreciation and investment incentives
- Appendix H: Reducing taxes on future generations
- Appendix I: Changes contingent on a capital gains tax
- Personal tax rates and thresholds
- Potential revenue-neutral packages – Paper I
- Potential revenue-neutral packages – Paper II

## Other topics

- Summary of submission from individuals
- Submissions from organisations and academics
- Financial transaction taxes
- Tax and gender
- Corrective taxes
- Taxation of retirement savings
- Government reviews that could impact the Tax Working Group
- Distributional analysis
- TWG's forward work plan and engagement strategy
- Final Report: Initial thoughts on outline
- Final Report – Revised outline
- Initial thinking on drafting Final Report
- Further update on taxing the digital economy
- Issues raised by New Zealand Superannuation Fund
- Presentation on cryptocurrencies and technology challenges facing Inland Revenue investigators
- Post Final Report process

## External advice

- The compliance costs of taxing capital gains (Chris Evans)
- Review of four background papers on company taxation (Professor Norman Gemmell)
- He Ara Waiora (Sacha McMeeking)
- A Māori perspective on environmental taxes and economic tools (Tina Porou)
- Impact of capital gains tax on residential housing markets (Andrew Binning and Andrew Coleman)
- Report on the suitability of establishing a tax ombudsman and a tax advocate (Terry Baucher)
- Presentation on intergenerational fairness (Young IFA Network – New Zealand)
- Removing the business income exemption for charities (Talia Smart)
- Full corporate-personal income tax integration: a fairer alternative (Matt Woolley)

## Selected notes from Tax Working Group members

- Purpose clauses and the tax legislation (Andrea Black, Sir Michael Cullen, Craig Elliffe)
- Extending the taxation of capital gains – minority view (Joanne Hodge, Kirk Hope and Robin Oliver)
- Presentation on tax collection challenges (Nick Malarao)
- Double taxation (Robin Oliver)
- Taxing share gains but not capital gains made by companies (Robin Oliver)
- Company tax rate issues – supplementary information (Bill Rosenberg)
- Note on taxation of labour (Bill Rosenberg)

## Selected notes from the Independent Advisor

- Retirement villages and capital income (Andrea Black)
- Small value disputes (Andrea Black)
- Taxation of high wealth individuals cover note (Andrea Black)
- Taxing capital gains from Māori collectively held assets (Andrea Black)
- Taxation of labour (Andrea Black)



# Appendix D: Tax Working Group Terms of Reference

The Tax Working Group has been established by the Government in order to examine further improvements in the structure, fairness and balance of the tax system.

The New Zealand tax system has been justifiably commended internationally for being a simple and efficient system. The Government's starting position is that the guiding principle for the New Zealand tax system – namely, that tax should operate neutrally and as much in the background as possible – is sound.

The Working Group will consider what improvements to this framework could improve the structure, fairness and balance of the tax system. In particular, the Working Group will consider the impact on the tax system of the likely economic environment over the next decade.

The Government has the following objectives for the tax system:

- A tax system that is efficient, fair, simple and collected;
- A system that promotes the long-term sustainability and productivity of the economy;
- A system that supports a sustainable revenue base to fund government operating expenditure around its historical level of 30 per cent of GDP;
- A system that treats all income and assets in a fair, balanced and efficient manner, having special regard to housing affordability;
- A progressive tax and transfer system for individuals and families, and

- An overall tax system that operates in a simple and coherent manner.

The Working Group should report to the Government on:

- Whether the tax system operates fairly in relation to taxpayers, income, assets and wealth;
- Whether the tax system promotes the right balance between supporting the productive economy and the speculative economy;
- Whether there are changes to the tax system which would make it more fair, balanced and efficient; and
- Whether there are other changes which would support the integrity of the income tax system, having regard to the interaction of the systems for taxing companies, trusts and individuals.

In examining the points above, the Working Group should consider in particular the following:

- The economic environment that will apply over the next 5-10 years, taking into account demographic change and the impact of changes in technology and employment practices and how these are driving different business models;
- Whether a system of taxing capital gains or land (not applying to the family home or the land under it), or other housing tax measures, would improve the tax system;
- Whether a progressive company tax (with a lower rate for small companies) would improve the tax system and the business environment, and

- What role the taxation system can play in delivering positive environmental and ecological outcomes, especially over the longer term.

In considering the matters above, the Working Group should have due regard to the overall structure of the tax system to ensure it is fair, balanced and efficient, as well as simple for taxpayers to understand and comply with their tax obligations.

The following are outside the scope of the Working Group's review:

- Increasing any income tax rate or the rate of GST;
- Inheritance tax;
- Any other changes that would apply to the taxation of the family home or the land under it, and
- The adequacy of the personal tax system and its interaction with the transfer system (this will be considered as part of a separate review of Working for Families).

In addition, the focus of the Working Group should not be on more technical matters already under review as part of the Tax Policy Work Programme, including:

- International tax reform under the Base Erosion and Profit Shifting agenda; and
- Policy changes as part of Inland Revenue's Business Transformation programme.

The Working Group will be able to recommend further reviews be undertaken on specific issues which the group considers it has not been able to explore sufficiently, or that were excluded from its Terms of Reference but which could benefit from being considered in the context of its recommendations.

The Working Group's membership will include individual(s) with expertise in Māori community and business environments.

The Working Group will be supported by a secretariat of officials from Treasury and Inland Revenue and it will be able to seek independent advice and analysis on any matter within the scope of its Terms of Reference. The Working Group will have an independent advisor to analyse the various sources of advice received by the Working Group and help to analyse and distil the information to assist the Working Group's deliberations. The Working Group will be expected to engage with the public in developing its recommendations.

The Working Group should have its first meeting no later than February 2018, issue an *Interim Report* to the Minister of Finance and Minister of Revenue no later than September 2018, and issue a final report to the Minister of Finance and Minister of Revenue no later than February 2019. These dates may be varied with the consent of the Minister of Finance.

# Glossary

**Accommodation supplement:** A non-taxable benefit payment that provides cash assistance for a person's accommodation costs in the private market (both owners and renters).

**Aggregate national income/gross domestic product (GDP):** The total value of goods and services produced in the economy in a year.

**Amalgamations:** A combination of the assets and liabilities of two or more companies into a new corporate entity.

**Arm's-length price:** The price that would be reached by a willing buyer and willing seller, acting in their own self-interest.

**Associated persons:** Parties can be associated through blood, ownership or other types of relationship (such as through a trust). The exact definition is in subpart YB of the Income Tax Act 2007.

**Base erosion and profit shifting (BEPS):** Strategies used by multinational companies to minimise their worldwide tax liability. The OECD has led work to counter these strategies with recommendations for upgraded international tax rules.

**Beneficiary income:** For a trust, beneficiary income is income of the trust that is allocated to a beneficiary and is taxed in their hands. (See also: trustee income.)

**Black-hole expenditure:** Business expenditure of a capital nature that is not deductible for tax purposes and does not give rise to a depreciable asset, so cannot be deducted as tax depreciation over time.

**Bracket creep:** The effect created when inflation increases a person's average tax rate because more of their income is taxed in higher tax brackets. (See also: inflation.)

**Bright-line test:** A rule that taxes gains on residential properties (that are not owner occupied) that are bought and sold within five years.

**Broad based, low-rate (BBLR):** A tax policy framework under which taxes apply to a wide range of income or consumption with few or no gaps or exemptions, allowing substantial revenue to be raised at relatively low rates of taxation.

**Building depreciation deduction:** A deduction for the depreciation of buildings. (See also: deduction, depreciation.) New Zealand has not allowed these deductions since a law change in 2010.

**Capital income:** Income that is a return on invested capital (i.e. income from owning something rather than from personal effort) such as interest, dividends, rental income, gains on the sale of capital assets and the return on capital invested in a business. (See also: labour income.)

**Carbon tax:** A tax imposed on the burning of carbon-based fuels.

**Closely held business/company:** Businesses that are owned by a small number of shareholders.

**Closing stock adjustment:** An accounting adjustment made to the value of stock on hand. This adjustment can have tax implications.

**Controlled foreign company (CFC):** Non-resident companies that are controlled by New Zealand shareholders. New Zealand has a regime (the CFC regime) to tax the income of such companies in some circumstances.

**Cost of capital:** In economics, cost of capital is the rate of return that investors require to contribute capital to a particular project.

**Current account:** An accounting term that means the balance of the amounts (other than capital) lent by a shareholder to a company and borrowed by the shareholder from the company.

**De minimis:** In tax, a rule with a de minimis would exempt amounts under a certain threshold from the general application of the rule.

**Deadweight loss:** In the tax context, this is the cost to society owing to individuals, households and firms making consumption and production choices to pay less tax, in the case where the tax is not intended to change behaviour deliberately.

**Deduction:** An amount subtracted from gross income as an allowable expense.

**Departure prohibition order:** A tax administration measure that can restrict a person from leaving the country owing to unsatisfied tax or other regulatory obligations.

**Depreciation:** The expected reduction in the value of an asset over time.

**Digital economy:** The part of the global economy that is based around the use of digital information.

**Dividend stripping:** A form of tax avoidance that converts a taxable dividend into a non-taxable capital gain for a shareholder.

**Donee organisation:** A status for an organisation that means donors to it can claim a tax credit for their donation.

**Double deduction:** When the same expense is able to result in more than one deduction.

**Double taxation:** When the same income is taxed more than once.

**Double tax agreement:** A treaty between tax jurisdictions on how cross-border income will be taxed in each country and to facilitate exchange of information and other forms of cooperation between tax administrations to assist with tax compliance.

**Economic rents:** The return on an investment greater than that needed for the investment to be viable.

**Ecosystem services:** The benefits people derive from ecosystems.

**Effective tax rate:** The rate at which real, pre-tax profits or income is taxed.

**Elasticity (of demand and supply):** In economics, elasticity measures the responsiveness of demand or supply to a change in price.

**Employer's superannuation contribution tax (ESCT):** The tax on employer contributions to an employee's superannuation scheme (such as KiwiSaver).

**Equalisation tax:** A tax targeted at the digital economy separate to the corporate income tax.

**Ex ante:** Based on forecasts rather than actual results.

**Excise:** A tax on the sale of a specific good. Excise taxes are indirect taxes, which means that the tax is levied on the producer of the good rather than the consumer and the amount of the tax is generally included in the price charged for the good.

**External debt:** The amount of debt (public and private) owed by a country to overseas creditors.

**Externality:** A consequence of an economic activity or transaction experienced by unrelated third parties.

**Fair dividend rate (FDR):** Method of taxing foreign shares held as a passive investment. Income is deemed to be 5% of the opening market value of shares and tax is paid on this amount.

**Financial arrangements:** In tax, most financial instruments other than shares are considered financial arrangements. New Zealand taxes parties to financial arrangements on an accruals basis over the life of the arrangement instead of when payments are actually made.

**Financial/physical capital:** This includes things like houses, roads, buildings, hospitals, factories, equipment and vehicles. These are the things that make up the country's physical and financial assets that have a direct role in supporting incomes and material living conditions.

**Financial transaction tax:** A tax on the purchase, sale, or transfer of financial instruments.

**Fiscal drag:** The additional personal income tax generated as an individual's average tax rate increases as their income increases.

**Foreign direct investment:** Overseas investment into New Zealand that is more substantial than passive investment. A New Zealand subsidiary of a foreign parent company is an example of foreign direct investment.

**Foreign investment fund (FIF) regime:** Rules for taxing New Zealanders on their foreign shares held as a passive investment. (See also: Fair dividend rate (FDR), which is part of the FIF regime.)

**Free allocation:** In relation to an emissions trading scheme, free allocation is a position of unrestricted trading of carbon credits.

**Fringe benefit tax:** A tax on most non-cash benefits provided by employers to employees.

**General anti-avoidance rule (GAAR):** A rule that counters tax avoidance arrangements by overriding other tax rules to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is tax avoidance.

**Generic Tax Policy Process:** The New Zealand Government's approach to developing tax policy. It has been used since 1994 and prioritises consultation.

**Gig economy:** The trend in workers having temporary jobs, less regularity in their working conditions and operating as independent contractors, in part owing to technological developments.

**Goods and services tax (GST):** A broad-based tax on consumption in New Zealand.

**Goodwill:** An intangible asset of a business recognised upon acquisition. Goodwill can include the value of brand, customer base and reputation.

**Hidden economy:** Economic activity that is not declared and goes untaxed.

**Horizontal equity:** The principle that people with similar income and assets should pay the same amount in taxes. (See also: Vertical equity.)

**Human capital:** This encompasses people's skills, knowledge and physical and mental health. These are the things that enable people to participate fully in work, study, recreation and in society more broadly.

**Imputation regime:** Regime that integrates company tax with personal income tax for residents, ensuring that residents are not double taxed on their income from companies.

**Imputed income:** A person can be said to receive imputed income if they provide a service to themselves instead of dealing with another person. For example, a person who owns a house can provide shelter for themselves without having to pay rent to a landlord. This benefit is imputed income of the person.

**Incidence:** The group or person who bears the burden of a tax. This can be who is required to pay the tax (legal incidence) or who bears the economic cost of the tax (economic incidence).

**Income decile:** A statistical term describing a 10% segment of a population that has been sorted according to its income. Decile 1 refers to the 10% of households with the lowest incomes and decile 10 refers to the 10% of households with the highest incomes.

**Indexation:** The adjustment of an amount (for example a tax liability or threshold) according to changes to the cost of living. (See also: bracket creep, inflation.)

**Inflation:** Inflation occurs when the prices for goods and services generally increase in an economy.

**Input tax deductions:** A GST-registered person can claim an input tax deduction for the amount of GST they paid on a good or service if it is to be used by them to make a further supply of a good or service that is subject to GST. For example, a retail shop that purchases goods wholesale can claim back GST on the wholesale price as an input tax deduction.

**Kaitiakitanga:** A Māori concept encompassing stewardship.

**Labour force participation:** The proportion of working-age population that are employed or are seeking to be employed.

**Labour income:** Income from personal effort, including salaries and wages (as well as the returns from the owner of a closely held business working in that business). (See also: capital income.)

**Land:** In this report, land generally means both the unimproved land as well as improvements made on the land, such as buildings. However, when referring to a land tax, it means solely the unimproved value of land.

**Land-banking:** The practice of buying land with no immediate plans for development.

**Land tax:** A tax on the *unimproved* value of land.

**Lease inducement payment:** An unconditional lump sum cash payment made by a person (usually a landlord) to induce another person to enter into a lease.

**Lease surrender payment:** A payment made by a person to their landlord or tenant in exchange for the surrender of a lease.

**Liquidity:** The ease with which an asset can be bought or sold on the market.

**Living standards framework:** An approach developed by the Treasury, based on four capitals (human, social, natural and financial and physical) for analysing living standards and intergenerational wellbeing.<sup>50</sup>

**Look-through company:** A type of closely held company in which the owners are jointly attributed with the income and expenditure of the company for tax purposes.

**Loss-continuity rules:** Rules based on continuity of shareholding that restrict when a company's losses can be carried forward and offset against income in future years.

**Loss ring-fencing:** A tax rule whereby a particular type of loss can only be offset against a particular type of income (usually of a similar character).

**Low value write-off threshold:** The maximum total value of an asset that can be immediately deducted on purchase. Assets with a higher value must be depreciated over their useful lives for tax purposes. The threshold is currently \$500.

**Manaakitanga:** A Māori concept encompassing care and respect.

**Māori authority:** A Māori ownership structure under New Zealand law that is taxed at a rate of 17.5%.

**Marginal effective tax rate (METR):** A theoretical measure of the tax rate on real, pre-tax income for investments that only just make economic sense.

**Marginal tax rate:** The rate of tax applied to the next dollar of income earned.

**Mātauranga Māori:** Refers to Māori systems of knowledge, understanding and wisdom.

**Member tax credit:** A contribution by the New Zealand Government to KiwiSaver members.

**National saving:** A country's total amount of savings, consisting of private savings and the Government's savings.

**Natural capital:** All aspects of the natural environment (i.e. ecosystems) that support life and human activity. It includes land, soil, water, plants and animals, as well as minerals and energy resources and the information that makes ecosystems function with integrity.

**Ngā Whenua Rāhui:** A Crown initiative that enables Māori land owners to partner with the Crown (through a covenant) to promote the protection of indigenous ecosystems on Māori land. The initiative is supported by a contestable fund and serviced by the Department of Conservation.

**Nominal income:** Nominal income is income before accounting for the effect of inflation. (See also: real return.)

**Ohanga:** A Māori concept encompassing prosperity.

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50 More information can be found here: <http://www.treasury.govt.nz/abouttreasury/higherlivingstandards>

**Passive income:** Income of a person sourced from activity that the person is not actively involved in. Interest, dividends and rent are examples of passive income.

**Pay as you earn (PAYE):** A tax-collection regime that requires employers to withhold tax on wage and salary income as it is earned and send it to Inland Revenue on behalf of employees.

**Payroll tax:** Tax paid by employers, employees or the self-employed, either as a proportion of payroll or as a fixed amount per person and that do not provide entitlements to social benefits.

**Permanent establishment (PE):** A physical presence of a non-resident taxpayer in a country that gives rise to tax obligations.

**Portfolio investment entity (PIE) rules:** The PIE tax rules apply to collective investment vehicles where investors combine resources to make investments. PIEs pay tax on investment income based on the prescribed investor rates of their individual investors. The prescribed investor rate is a final rate and is capped at 28%. There is no additional layer of tax when a PIE makes distributions to investors.

**Productivity:** A measure of the rate of output per unit of input.

**Progressive:** A progressive tax rate structure has higher rates for higher levels of incomes.

**Provisional tax:** A tax administration regime that requires some taxpayers such as companies and the self-employed to pay income tax instalments during the year on income that has not had tax deducted at source (for example, through PAYE).

**Purchasing power:** The value of income or currency in terms of the goods and services that it can buy.

**Real return:** This is the nominal return adjusted for inflation. It is a closer estimation of economic income compared to the nominal return because it preserves the value of capital over time. (See also: **nominal income**.)

**Regressive:** A regressive tax has a higher rate for lower levels of incomes.

**Relationship property:** Property that must be divided between the parties in a relationship when their relationship ends.

**Revenue account property:** Property that, for the purpose of tax law, is already taxed on all capital gains. This is property that is either trading stock or property that, if disposed of for valuable consideration, would give rise to income under the Income Tax Act (with some exceptions).

**Risk-free rate of return:** This is the expected rate of return that a completely risk-free investment generates. The difference between the risk-free return and the expected return on a risky investment is sometimes called a risk premium.

**Robot tax:** A tax on the use of a robot that replaces a human worker.

**Rohe:** the territory of an iwi.

**Rollover relief:** In the context of taxation of capital income, rollover relief delays taxation in certain circumstances when a capital gain is realised.

**Seismic strengthening:** Improvements made to a building to improve its ability to withstand an earthquake.

**SME:** Small and medium-sized enterprises.

**Social capital:** The norms and values that underpin society. It includes things like trust, the rule of law, the Crown/Māori relationship, cultural identity and the connections between people and communities.

**Social security contributions:** Compulsory payments to government that provide an entitlement to receive a future benefit.

**Sole trader:** A person doing business in their own name with no separate legal entity.

**Sustainable economy:** In the context of this report, a sustainable economy refers to a circular, regenerative, ecological economy that maintains and enhances natural capital and where ecosystems are resilient and function with integrity.

**Tax Policy Work Programme:** A programme (with periodic updates) signalling the Government's plan for current and future tax policy work.

**Tax pooling:** A system that allows tax payers to pool tax payments, offsetting underpayments by overpayments within the same pool.

**Tax secrecy:** The set of rules that require Inland Revenue to maintain secrecy on all matters relating to tax unless an exception applies.

**Te Ao Māori:** A Māori world view.

**Tikanga:** The custom, rules and lore associated with a Māori world view.

**Trading stock:** Stock that is held for the purpose of trading it as part of a business.

**Transfer system:** Government spending paid in cash rather than in kind, including benefits and Working for Families tax credits.

**Trust:** An arrangement whereby a person (a trustee) holds property as its legal owner for one or more beneficiaries.

**Trustee income:** For a trust, income that has not been allocated to a beneficiary is trustee income. The trustees of the trust are jointly liable to pay the tax on trustee income. (See also: beneficiary income.)

**Trustee rate:** The tax rate that is applied to trustee income.

**Universal basic income:** An unconditional payment from the Government to all eligible citizens.

**Value-added tax (VAT):** A VAT is a type of transaction-based consumption tax that is levied at each stage where value is added in the production process and at the point of sale. New Zealand's GST is a form of VAT. (See also: GST.)

**Vertical equity:** The principle that those with higher income should pay higher rates of tax. (See also: Horizontal equity.)

**Welfare Expert Advisory Group (WEAG):** A working group set up by the Government to undertake a broad review of the welfare system. The WEAG will provide a report to the Government in February 2019.

**Whanaunatanga:** A Māori concept encompassing relationships and connectedness.

**Withholding taxes:** Taxes deducted at the time a payment is made e.g. employment income (PAYE), interest income (resident withholding tax (RWT)).

**Windfall gain:** An unexpected increase in wealth or income.

**Winding up of a company:** The end of a company's existence (also known as liquidation).

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