Future of Tax

Final Report Volume II

Design Details of the Proposed Extension of Capital Gains Taxation

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'

New Zealand Government

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Introduction

1. The Government established the Tax Working Group to examine further improvements in the structure, fairness and balance of the tax system. The Terms of Reference asked the Group to consider whether a system of taxing capital gains (not applying to the family, or main, home or the land under it – referred to in this report as the 'excluded home'), would improve the tax system.

2. The Government's objective, as stated in the Terms of Reference, is to have a tax system that:

    - is efficient, fair, simple and collected
    - promotes the long-term sustainability and productivity of the economy
    - supports a sustainable revenue base to fund government operating expenditure around its historical level of 30% of GDP
    - treats all income and assets in a fair, balanced and efficient manner, having special regard to housing affordability
    - is progressive, and
    - operates in a simple and coherent manner.

3. Whether a system of taxing capital gains can meet these objectives is dependent on the design features. This Volume outlines the detailed design decisions made by the Group for taxing capital gains. The Group's views as to whether a system of taxing capital gains based on these features would meet the above objectives are stated in Chapter 5 of Volume I.

4. This Volume builds on the decisions outlined in Appendix B of the Group's *Interim Report* and takes into account the Group's further thinking on the issues and feedback received from consultation on the *Interim Report*.

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What should be taxed?

Included assets

1. The taxation of capital gains should be extended to a list of 'included assets', being:

   - land, including improvements to land (other than the excluded home)
   - shares
   - intangible property, and
   - business assets.

2. Those assets, as well as the assets that should be excluded from an extension of the taxation of capital gains, are discussed in this chapter.

Land

3. In some circumstances capital gains from the sale of land are already subject to tax. Capital gains from the sale of all land, including improvements to land, and leasehold interests should be subject to tax. This includes residential property, such as rental properties, and second homes, including holiday homes, baches and cribs. This also includes all commercial, agricultural and industrial land.

4. However, gains from the sale of a person's main home will not be taxed (see the following discussion from paragraph 15 on the excluded home). Māori Freehold Land under Te Turi Whenua Māori Act 1993 could also be excluded from an extension of the taxation of capital gains (see following from paragraph 42).

Example 1: Rental property

Aroha owns a rental property. Any capital gains arising from the sale of the rental property (i.e. sale proceeds less allowable deductions for costs of acquisition and improvements (discussed in Chapter 4)) will be taxable income for Aroha.

Example 2: Holiday home

In addition to his main home, Jordan owns a holiday home in the Coromandel Peninsula. Any capital gain arising from the sale of the holiday home will be taxable income for Jordan.

5. Gains from the sale of land owned by a New Zealand resident, where that land is located in another country, will also be subject to tax. If a gain on land is taxed in the country in which it is located, New Zealand would allow a foreign tax credit to the extent of any double taxation.

Example 3: Foreign land

Manu owns a holiday home in Queensland, Australia. Any capital gains arising from the sale of the Queensland holiday home will be taxable income for Manu. To the extent that Manu is also taxed on his capital gain in Australia, he would receive a foreign tax credit that can be credited towards his New Zealand income tax liability.

Shares

6. All capital gains from the sale of shares in New Zealand and foreign companies[1] should be taxed. More detail on how shares should be taxed is discussed below in Chapter 7 *Taxation of New Zealand shares* and Chapter 8 *Taxation of foreign shares*.

Example 4: Share portfolio

James has a portfolio of shares in various New Zealand and Australian listed companies that he holds as a long-term investment. Any capital gains arising from the sale of the shares will be taxable income for James.

Example 5: Shares in a small business

Tama owns 100% of the shares in his small consulting company, Consult Me Limited. Any capital gains arising from the sale of the shares in Consult Me Limited will be taxable income for Tama.

7. However, most sales or redemptions of interests in portfolio investment entities (PIEs) including KiwiSaver funds, should remain exempt from tax. Income earned by a KiwiSaver or other managed fund will continue to be taxed in the fund. See the discussion in Chapter 9 *Taxation of KiwiSaver and other managed funds*.

Example 6: KiwiSaver fund

Rebecca has funds invested in a KiwiSaver fund. Rebecca will not be taxed when she withdraws her funds from the KiwiSaver fund.

8. Where a person (including a trustee) owns a share in a flat-owning company[2] and the person occupies part of the property owned by the flat-owning company as their main home, any sale of that share will not be subject to tax (see the discussion below from paragraph 16 on the excluded home).

Intangible property

9. All capital gains from the sale of intangible property owned or created for business purposes should be subject to tax, with specific exclusions where necessary. Intangible property, otherwise known as a 'chose in action', represents all personal rights of property that can only be claimed or enforced by legal action. Examples include goodwill, intellectual property such as patents, trademarks and copyrights, software, debt instruments, contractual rights and insurance policies.

Example 7: Intangible property

Café Limited runs a café. The café has developed goodwill through its operations. It also holds a registered trademark in respect of its logo.

If the business is sold, any capital gains arising from the sale of the goodwill and trademark will be taxable income for Café Limited.

10. Given the breadth of asset types that the term 'intangible property' covers, it is impossible to provide a comprehensive list of particular types of intangible property. While a wider approach may initially create some additional uncertainty, in the longer term it should provide greater certainty, as it should mean fewer periodic updates. It will also likely lead to a relatively quicker discovery of any further areas that should be excluded.

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1 Note that the tax treatment for shares in foreign companies that are already subject to the fair dividend rate method under the foreign investment fund rules, and the tax treatment for shares in non-attributing controlled foreign companies and non-portfolio (i.e. holdings of more than 10%) foreign investment funds held by companies, will not materially change.

2 A flat-owning company is one where every shareholder is entitled to use of a property owned by the company and whose only significant assets are those properties and funds reserved for meeting costs.

11. The following items of intangible property should be expressly excluded from the scope of an extension of the taxation of capital gains:

- intangible property that is already subject to tax under the financial arrangement rules, (e.g. debt instruments and derivatives), and
- intangible property that is held for personal use (discussed further in paragraph 39).

12. As part of the Government's policy development and consultation process (generic tax policy process) further consideration should be given to other types of intangible property that should be specifically excluded from the extension of the taxation of capital gains. In particular, further consideration should be given to:

- traditional cultural assets, including Māori cultural assets[3]
- how an extension of the taxation of capital gains will interact with other intangible property that is already subject to specific rules that tax the increase in value of the asset, e.g. patent rights, emissions units under New Zealand's Emissions Trading Scheme (ETS), forest cutting rights and petroleum permits.

13. Consideration should also be given to whether any of those specific rules for intangible property can be rationalised in light of an extension of the taxation of capital gains.

Business assets

14. Capital gains from the sale of all other assets held by a business, or for income-producing purposes should be taxed. This would include depreciable assets, e.g. plant and equipment but would not include trading stock, i.e. stock that is held for the purpose of trading it as part of a business. Trading stock and revenue account property (discussed in paragraph 46) would continue to be taxed under the current rules.

Example 8: Mechanic business

Mechanic Limited runs a mechanic business. Mechanic Limited's assets consist of the land and buildings that it operates out of, various plant and equipment and the goodwill that it has generated over the time the business has been operating. It also has a stock of parts that it uses in the course of its business.

If the business is sold, any capital gains from the sale of the land and buildings, plant and equipment and goodwill, will be taxable income for Mechanic Limited.[4] However, sales of the parts in the course of carrying on Mechanic Limited's business will not be subject to the new tax. Instead, sales of the parts will be taxed under the current trading stock rules.

Excluded assets

15. While there is a list of included assets, rather than taxing all capital gains, there are some assets that should be explicitly excluded (some of which are discussed elsewhere).
This section discusses:

- the excluded home, and
- personal-use assets.

The excluded home

16. The Terms of Reference require that the Group excludes the family, or main, home and the land under it from any extension of the taxation of capital gains. Therefore, there should be an exclusion for a person's family, or main, home (the excluded home).

17. The rest of this section explains the definition of an excluded home.

3 In this context, the Group notes there have been instances where a right has been provided in relation to particular Māori taonga, as part of a Treaty settlement. For example, the Haka Ka Mate Act 2014 requires those performing the haka in commercial situations to include a prominent statement that Te Rauparaha was the composer of Ka Mate and a chief of Ngāti Toa Rangatira. In practice, the Group expects the likelihood of Māori selling such rights would be rare.

4 See Chapter 4 for a brief discussion on how an extension of the taxation of capital gains will apply to depreciable property.

What is an excluded home?

18. An excluded home should be defined as the place that a person owns, where they choose to make their home by reason of family or personal relations or for other domestic or personal reasons. This test is based on the test used in s72(3) of Electoral Act 1993.

Example 9: Place that is a person's home

Piri owns a property in Wellington. He lives in the property and keeps all his possessions there.

The Wellington property will be Piri's excluded home. It is the place that he owns where he chooses to make his home.

19. Usually, a couple will only have one excluded home between them, because there will only be one place that they choose to make their home together. However, where a couple ends their relationship and subsequently live separately, they should each be allowed a separate excluded home. In rare situations, it may be possible for a couple to live separately and have separate excluded homes. However, this would only be allowed for a period of three years.

Example 10: Couple has separated

Natalie and Sarah have been married for 7 years. During that time they lived together in a home in Tauranga. Their relationship breaks down and they decide to end their relationship. Natalie remains in the Tauranga house and Sarah purchases a new home.

Prior to their separation, the Tauranga house was Natalie and Sarah's excluded home. However, after their separation, Natalie and Sarah have separate properties where they choose to make their homes. Therefore, from the time of their separation, they can each have a separate excluded home.

Example 11: Separate homes

John and Trudy are married. However, they each own separate homes they acquired before meeting each other. The homes are each separately (not jointly) owned by John and Trudy.

Despite being married, John and Trudy choose to continue to live in their separate homes, as they have always done before getting married. John has three children from a previous relationship who live with him in their home in Hamilton. Meanwhile, Trudy has one child and a cat who live with her in their home in Auckland. John's children go to school in Hamilton, while Trudy's child goes to school in Auckland. John runs a small business from Hamilton, while Trudy works in central Auckland. John's and Trudy's personal property is also kept separately in their respective separate homes.

Taking all facts into account, it can be said that John has chosen to make his home in Hamilton by reason of his family and personal relations in Hamilton, while Trudy has chosen to make her home in Auckland. As John and Trudy genuinely live separately in two different homes, John and Trudy can each have a separate excluded home. However, this can only be the case for three years, after which only one property will be the couple's excluded home.

20. There should be an anti-avoidance provision to stop people from artificially creating a situation where a couple can have two excluded homes.

Who can own an excluded home?

21. An excluded home should be a property owned separately or jointly by the person who uses it as a residence. An excluded home can also be:

    - a property owned by a trust, if a person occupying the property mainly as their residence is:

        - a settlor of the trust, or
        - a beneficiary of the trust who becomes irrevocably entitled to the property or to the proceeds from the sale of the property as beneficiary income

- shares in a flat-owning company, if a person who owns the shares occupies the property mainly as their residence
- a property owned by an ordinary company or look-through company, if the person who owns the shares occupies the property mainly as their residence, or
- shares in a flat-owning company, or a property owned by an ordinary company or look-through company, where the shares in the flat-owning company, ordinary company or look-through company are owned by a trust and the person occupying the property mainly as their residence is:
    - a settlor of the trust, or
    - a beneficiary of the trust who becomes irrevocably entitled to the property or to the proceeds from the sale of the property as beneficiary income.

Example 12: Excluded homes in a family trust

The Hunia Family Trust was settled by Mr and Mrs Hunia. The Hunia Family Trust owns four residential properties. One of the properties is occupied by Mr and Mrs Hunia as their family home. This will be an excluded home.

The other three properties are each occupied as a main home by Mr and Mrs Hunia's three children, Ariki, Tui and Kauri and their families.

The trustees resolve to distribute the properties occupied by Ariki and Tui to Ariki and Tui. The disposal of these properties by the Hunia Family Trust will not give rise to tax because the properties will qualify as excluded homes.

The trustees resolve to sell the property occupied by Kauri and distribute the sale proceeds to Kauri as beneficiary income. The sale of the property will not give rise to tax because the property will also qualify as an excluded home.

Example 13: Property held by a family trust that is not an excluded home

The Jones Family Trust was settled by Mr and Mrs Jones. The Jones Family Trust owns a residential property in Dunedin. The Dunedin property is occupied by Mr and Mrs Jones' daughter as her home for four years while she attends university. The Dunedin property is then rented to a third party for one year before being sold. The Jones Family Trust reinvests the sale proceeds.

The Dunedin property will not qualify as an excluded home. It was not occupied by a beneficiary of the trust who became irrevocably entitled to the property or the proceeds of sale.

22. Only New Zealand tax residents (who are not treated under a double tax agreement as being non-resident) should be entitled to have an excluded home in New Zealand (subject to certain 'change-of-use exceptions', discussed further in Chapter 5).

Example 14: New Zealand property owned by a non-resident

Jonathan owns a property in Auckland, which he lived in for 10 years with his family. In 2018, Jonathan and his family moved to Melbourne and purchased a house there. Jonathan works primarily in Melbourne and his children attend school there. However, Jonathan retained his Auckland property, which he stays in regularly when he is in Auckland for business. The family also spend their holidays in the Auckland property from time to time.

Because Jonathan retained his Auckland property, which he continues to use, he will still be a New Zealand tax resident (because he has a permanent place of abode in New Zealand). However, because Jonathan and his family live in Melbourne, Jonathan will also be an Australian tax resident. Under the double tax agreement between Australia and New Zealand, Jonathan will be deemed to be a tax resident only of Australia, because his personal and economic relations are closer to Australia.

Because Jonathan is treated under the double tax agreement as not being a New Zealand tax resident, the Auckland property cannot be an excluded home.

Only one excluded home

23. A person, or a person and their family living with them, should only have one excluded home at any one point in time. If a person has two properties, they will need to determine which property is the one that is their excluded home.

Example 15: One excluded home

Karen and her husband Sione own a house in Wellington where they live with their two small children (ages 5 and 7). Karen and Sione both work in Wellington and the children go to school in Wellington. However, Karen often has to travel to Auckland for work, so the couple decides to buy an apartment in Auckland. The apartment is jointly owned in Karen and Sione's names.

Karen stays in the apartment two or three days each week when she is required to be in Auckland for work. The rest of the time Karen lives in Wellington with her family. Sometimes the family travels to Auckland for a long weekend or a holiday and stay in the Auckland apartment. The family spends approximately six weeks in total each year in the Auckland apartment together.

Although Karen and Sione own two properties, only the Wellington house can be their excluded home because that is where Karen and Sione have chosen to make their home by reason of their family or personal relations, or for other domestic or personal reasons and the family spends most of their time there.

24. If a person has more than one property that could satisfy the requirements to be an excluded home, i.e. that is a place that the person owns, where they choose to make their home by reason of family or personal relations or for other domestic or personal reasons, they should be required to make an election as to which property is their excluded home. The election should be made when the first property is sold. If a person elects that the first property sold was their excluded home, the second property should not be an excluded home for the same period.

Example 16: Election

Mark and Marijke own properties in Invercargill and Wanaka. They spend equal amounts of time in each property during the year and keep personal possessions in both properties. Both properties could be said to be Mark and Marijke's home.

In 2025, Mark and Marijke decide to sell their Invercargill property. At the time of sale they elect that the Invercargill property was their excluded home for the whole time it was owned. In 2035 Mark and Marijke sell their Wanaka property. The Wanaka property can only be Mark and Marijke's excluded home from 2025 to 2035 (i.e. the period after the Invercargill property was sold).

Exceptions

25. There should be two exceptions to the general rule that a person, or a person and their family living with them, can only have one excluded home.

26. Where a person, or a person and their family living with them, purchases a new home but has not yet sold their original home, both properties should be excluded homes for up to 12 months while the original home is held for sale. The original home must have been used as the person's excluded home and the person must have purchased the new home with the intention that it will be used as the person's excluded home going forward.

Example 17: Sale and purchase

Cath and Will own a property that they have occupied as their excluded home. They decide to move to another area. They find a new home, purchase it and move into it. However, it takes three months to sell their old home. While it is on the market, the old home is left vacant.

Cath and Will's old home and their new home will both be excluded homes for the three months they own both.

27. The same principle should also apply where a single person moves out of their excluded home into a rest home. The person's original home should remain an excluded home for up to 12 months. The original home can be rented while it is being held for sale.

28. A person, or a person and their family living with them, should also be able to have two excluded homes for up to 12 months when they purchase vacant land to build a new home. The vacant land must be purchased with the intention of building a home that will be the person's excluded home when it is completed and the other property must be occupied by the person as their current excluded home.

Example 18: Building a new home

Arena and Herangi have a home in central Wellington. They decide to purchase a vacant section in the outer suburbs and build a new home for themselves. It takes one year from the date of purchase of the vacant section for the new home to be built. During that time Arena and Herangi continue to live in their central Wellington home. Once the new home is completed, Arena and Herangi sell their central Wellington home and move into their new home.

Both properties can be treated as excluded homes for the 12 months that Arena and Herangi own both.

Example 19: Building over a longer period

Jason and Kim have a home that they have occupied for a number of years. They decide to purchase some vacant land, with the intention of building a new home for themselves. They hold the land for three years before they start to develop plans. Once they start to develop plans, it takes a further three years to complete the home. Once the new home is completed, Jason and Kim sell their old home and move into their new one.

Jason and Kim can treat both properties as their excluded home but only for a period of 12 months.

29. A person will not be entitled to have two excluded homes (as a result of the exceptions discussed in paragraphs 25 to 28) for more than 12 months. If a person holds both properties for more than 12 months there will be a deemed change of use of the original property from the date the use originally changed (discussed in Chapter 5).

Land under an excluded home

30. The excluded home should include the land under the house and the land around the house up to the lesser of 4,500m^2 or the amount required for the reasonable occupation and enjoyment of the house. However, this land area allowance should be monitored and reduced if necessary.

31. Where the total area of the property is greater than 4,500m^2, or is not required for the reasonable occupation and enjoyment of the house, the gain on sale should be apportioned on a reasonable basis.

Example 20: Land under an excluded home

The Farmers own a 100-acre sheep farm. Approximately 4,000m^2 of the land comprises the Farmers' house and gardens. The remainder of the property is devoted to business purposes.

Only the area of the house and gardens is part of the excluded home. When the Farmers sell the land, they obtain a valuation of the area comprising the house and gardens, compared to the rest of the property. The valuation confirms that the house and gardens make up approximately 15% of the value of the whole farm.

On that basis, only 15% of the total gain on sale can be allocated to the excluded home.

Partial use of an excluded home for income-earning purposes

32. Where a person uses part of their property for income-earning purposes, while they are also living in the property (e.g. where there is a home office, a room is used for Airbnb or where a person has flatmates), the person should have two options as to how the property should be taxed:

    - provided the property is used more than 50% as the person's home, a person can choose to treat the entire property as their excluded home. However, the person will be denied any deductions for costs relating to the property, e.g. rates and interest, in relation to their income-earning use. The person will still be required to return their income from the income-earning use
    - alternatively, if the person wants to take deductions relating to their income-earning use of the property, the person can choose to apportion their capital gain when they sell the property and pay tax on the portion that represents their income-earning use.

33. In determining the use of the property, it will be necessary to take into account both the floor area used for income earning versus private purposes and the time that the property is used for income-earning purposes.

34. The following examples illustrate how this will apply:

Example 21: Home office

Dinesh owns a five-bedroom house that he uses as a residence for himself and his family. He also runs a consulting business out of one room in his house. As the area of the house used for income-earning purposes is minor and the house is more than 50% used as a residence, Dinesh can choose that the entire property will be an excluded home. However, if Dinesh chooses this option, he will not be entitled to claim any deductions for expenses relating to the property against the income from his consulting business.

Example 22: Airbnb

Mary purchases a house, which she occupies as her main home. The house has two living areas, one of which has a small kitchenette. Mary decides to advertise the use of one of the bedrooms and the second living area with the small kitchenette (approximately 33% of the total floor area of her house) on Airbnb. Mary has paying guests staying in her house for an average of 50 days each year. Mary uses those areas for her own private use at other times of the year.

Both the area used (33% of the floor area) and time the area was used for income-earning purposes (an average of 50 days a year) amount to less than 50% income-earning use of the property. Therefore, Mary can choose that the entire property will be an excluded home. However, if Mary chooses this option, she will not be entitled to claim any deductions for the expenses relating to the property against her Airbnb income.

Example 23: Flatmates

Thomas owns a four-bedroom house. To assist with paying his mortgage, Thomas rents out two of the bedrooms (approximately 25% of the floor area of the house). He also shares the use of the living areas (33% of the floor area of the house) with his flatmates.

In this scenario, the living areas are being used simultaneously for both private purposes, i.e. this is part of Thomas' residence, and for income-earning purposes (as part of the area that is being rented out).

The property is more than 50% used by Thomas as his residence. He has exclusive access to two of the four bedrooms and shared access to the living areas. Therefore, Thomas could choose to treat the entire property as an excluded home. However, Thomas wants to claim deductions for his expenses relating to the property, particularly for his interest expense, against his income from his flatmates' rent. Therefore, when he sells, Thomas will need to pay tax on the portion of the property that was used for income-earning purposes.

Thomas will be required to apportion the net sale proceeds based on the floor area devoted entirely to income-earning use, i.e. 25% of the total floor space. Thomas will also be required to make an apportionment to account for the partial income-earning use of the living areas. This would be based on 50% of the gain attributed to that 33% of the house. Inland Revenue guidance states that expenditure relating to common areas can be apportioned as 50% private and 50% deductible. A similar principle could be applied to apportioning net sale proceeds under a new tax on capital gains.

This would result in approximately 41.5% of the gain on sale being taxable (25% + (33% × 50%)). For example, if the property was sold for a $100,000 gain the calculation would be as follows:

- (100,000 × 25%) + ($100,000 × 33%) × 50% = $41,500 taxable capital gain

Example 24: Boarders

Moana and Tama own a property they use as their home. They own the property for 10 years. For two of those years Moana and Tama have a Japanese exchange student, Aiko, living in their home as a boarder. They are provided money from the school for their boarding services.

The property is used more than 50% as Moana and Tama's residence. Therefore, Moana and Tama could choose to treat the entire property as their excluded home. However, if Moana and Tama decide to do this, they will not be entitled to any deductions for expenses relating to the property against the board income they received.

Moana and Tama will have to choose between two options:

- treat the entire property as their excluded home. In this case determination DET 05/03: *Standard-Cost Household Service for Boarding Service Providers* will not apply as no deductions will be available. Moana and Tama will have to return the board income as taxable income
- choose to apply DET 05/03 and not return their board income but apportion the capital gain when they sell their home and pay tax on the portion that relates to the income-earning use based on area and time.

35. When a property is used more than 50% for income-earning purposes, e.g. as a boarding house, or where a person has a four bedroom house with three flatmates, a person will be entitled to apportion the capital gain on sale and treat the part of the property used as a residence as an excluded home.

Example 25: Part of a larger building used for private purposes

Ruby owns a five-bedroom property that she uses to run a bed and breakfast business. Ruby uses four of the bedrooms and most of the living areas for the bed and breakfast business. However, Ruby occupies one of the bedrooms and a small living area and bathroom attached to that bedroom, as her residence – approximately 20% of the floor area of the property.

The 20% of the property used as Ruby's residence can be treated as an excluded home and Ruby would only have to pay tax on 80% of the gain on sale.

High-value homes

36. In the *Interim Report*, the Group raised the possibility of applying a limit on the value of an excluded home for higher-value homes. This option is raised as a potential option for mitigating the 'mansion effect', where people invest more capital in their main home where it can generate untaxed capital gains.

37. The Group considers this to be outside its Terms of Reference and so has not considered it further. However, the Group recommends that this option be considered by the Government.

Personal-use assets

38. The extension of the taxation of capital gains should not apply to personal-use assets held by individuals and by trusts where the assets are available for the personal use of beneficiaries. This would include cars, boats and other household durables. These types of assets generally decline in value and the loss on sale represents the cost of having private, non-taxed, consumption benefits. Taxing these types of assets would also significantly increase the number of taxpayers impacted by an extension of the taxation of capital gains. However, this exclusion would not apply to land held for private purposes.

39. Personal-use assets will include intangible property not owned or created for business purposes. This would include intangible property, such as rights to benefit under a trust or will, personal insurance policies and occupation rights relating to a retirement village.

40. This exclusion would also apply to jewellery, fine art, taonga and other collectables (rare coins, vintage cars etc). The Group accepts that these assets are distinguishable from other types of personal-use assets because they are often purchased as investments and are usually expected to increase in value. Excluding these types of assets from an extension of the taxation of capital gains may incentivise investment in such assets over more productive assets. However, at this time, the Group proposes to exclude these assets for reasons of simplicity and compliance cost reduction. This concession should be monitored and, if necessary, revisited in the future, either entirely or by tax applying over a certain threshold.

Example 26: Personal-use assets

Penny owns an artwork. The artwork will be a personal-use asset and will not be subject to an extension of the taxation of capital gains.

41. As noted below (from paragraph 46) if personal-use assets are revenue account property they will continue to be subject to tax.

Assets and entities under Te Ture Whenua Māori Act 1993

42. Māori Freehold Land (as defined in Te Ture Whenua Māori Act 1993) is a type of collectively owned land that comprises approximately 1.4 million hectares (5%) of the total land mass of New Zealand (Ministry of Justice, 2017). It is a place of cultural significance through which Māori connect with their whānau through whakapapa. Māori Freehold Land is typically owned by individual Māori who have shares together as tenants in common. However, unlike for other land in New Zealand, Te Ture Whenua Māori Act sets strict rules applying to Māori Freehold Land that are intended to keep such land in Māori control. In practice, this means that Māori Freehold Land is rarely sold.

43. Due to the distinct context of Māori Freehold Land, the Group considers that Māori Freehold Land and interests in Māori Freehold Land held via an entity governed by Te Ture Whenua Māori Act (e.g. an ahu whenua trust or Māori incorporation) merit specific treatment under an extension to the taxation of capital gains. This could take the form of an exclusion (either generally, or only to the extent that proceeds from the sale of part of the land is reinvested in other Māori Freehold Land), or it could be built into the rollover principles discussed below in Chapter 3. The Government should engage with Māori in order to determine the specific treatment to be used.

44. The Group has not made a specific decision on the treatment of interests in such Māori entities (i.e. beneficial interests relating to individuals) that own assets other than Māori Freehold Land. This issue should be explored further through consultation as part of the generic tax policy process. In a practical sense, the ownership base of a Māori authority (being one of whakapapa or birth right) will generally increase with population growth, with no corresponding new investment by new owners. As a result, Māori authorities tend to experience perpetual shareholder dilution and so any capital gains made on ownership interests are likely to be non-existent or very small.

45. Assets and entities under Te Ture Whenua Māori Act will have ordinary rollover treatment under the rollover principles discussed in Chapter 3 below, except for some circumstances for which specific treatment is warranted. See the section *Māori collectively owned assets* from paragraph 24.

Revenue account property

46. As mentioned above, under the current law, a capital gain from the sale of some assets is already subject to tax. Those assets are referred to as 'revenue account property', which is defined in the Income Tax Act 2007 as:
    - property that is trading stock of the person, or
    - property that, if disposed of for valuable consideration, would give rise to income under the Act (with some exceptions).

47. Revenue account property includes property that was acquired with a purpose of disposing of it.

48. Assets that are 'revenue account property', including personal-use assets, will continue to be taxed under the current law. However, where loss ring-fencing is proposed for a type of property (discussed in Chapter 4) the same rules should also apply if that type of property is held as revenue account property (except for trading stock).

Summary

49. The following table summarises what are included assets and what are excluded assets.

Included assets

- Land and improvements to land (not including the excluded home)
- Shares not including shares in foreign companies that are already subject to the fair dividend rate (FDR) method, non-portfolio interests in foreign companies (i.e. interests of 10% or more) that are taxed under the foreign investment fund (FIF) rules and shares in non-attributing controlled foreign companies (CFCs)
- Intangible property owned or created for business purposes.
- Other business assets, including depreciable property but not including trading stock.

Excluded assets

- The excluded home.
- Personal-use assets (including intangible property that is a personal-use asset)

3

When to tax?

1. Tax should be imposed on a realisation basis in most cases. Under a realisation basis, taxpayers are taxed on the increase in value when they dispose of their included assets.

When is an asset disposed of?

2. A disposal of an included asset (also referred to as a realisation event) will usually involve a transfer of legal ownership. The typical case would be a sale for consideration, either in cash or in kind, e.g. a barter transaction or asset trade. Realisation will also arise despite payment of the consideration being deferred for a shorter or longer period and where assets are transferred for no consideration, e.g. transfers on death, gifts, transfers of relationship property and settlements on/distributions from trusts.

3. Consistent with current law, assets will also be treated as realised where they are destroyed or scrapped and when they are abandoned or no longer available for use.

When realisation events will be deemed to occur

Change of use

4. A realisation event should be deemed to occur when a person changes the use of their asset so that it ceases to be an included asset. For example, this may occur when a person who owns a rental property starts using it as their excluded home. Rules for taxing this deemed realisation are described in Chapter 5.

Migration

5. A realisation event should be deemed to occur when a New Zealand resident, who owns certain included assets, migrates to another country and removes those assets from the tax base. Detailed rules for this deemed realisation are discussed below in Chapter 5.

When realisation events will be ignored

6. There are, however, some situations where a realisation event should be ignored. This treatment recognises that, in some situations, it is fairer or more efficient not to tax the resulting gain or loss, despite the asset having been realised (in accordance with the principles discussed in Chapter 5 of Volume I). This treatment is referred to as a 'rollover'.

7. Under rollover treatment, the taxation of a capital gain or deduction of a capital loss is deferred until there is a later realisation event that is not eligible for rollover treatment. Instead of taxing the gain when the asset is initially realised, the cost base, i.e. the cost that a person pays to acquire and improve an asset, is rolled over into a replacement asset or to the new owner of the asset, who is taxed on the entire gain when they realise the asset.

Example 27: Rollover treatment

Alison buys a holiday home for $500,000. When Alison dies, she leaves the holiday home, worth $700,000, to her children. The children sell it 5 years later for $950,000.

If the transfer of the holiday home to Alison's children is treated as a realisation event that is not eligible for rollover treatment:

- Alison will have $200,000 of taxable income at the time of her death, which will be returned by her executor/administrator
- Alison's children will have taxable income of $250,000 when they sell the holiday home 5 years later.

If the transfer is eligible for rollover treatment:

- Alison will be treated as having no taxable income from the holiday home on her death
- Alison's children will have taxable income of $450,000 when they sell the holiday home five years later.

Life events (death, gifting and separation)

8. The excluded home, art, vehicles and other personal-use assets should not be subject to an extension of the taxation of capital gains and can be gifted or inherited with no tax implications. Cash, bonds and term deposits are outside the scope of the new rules, as they are already fully taxed. Therefore, the new rules will only apply to included assets, such as rental properties, other land and shares.

9. Where the excluded home is transferred on death, and the beneficiary uses it as their excluded home, it will continue to be an excluded asset for the beneficiary. If the beneficiary uses it for any other purpose it will become an included asset for the beneficiary from the time it is transferred to them, with the cost base being the market value at the time of transfer.

10. Rollover should be provided for all included assets that are transferred to a person's spouse, civil union partner or de facto partner, e.g. as a gift or when the person dies. This is because the couple would already be considered to have shared ownership interests in many of these assets. Rollover should also apply where included assets are transferred as part of a relationship property settlement (i.e. when a marriage, civil union or de facto relationship is dissolved).

11. Where included assets are transferred on death of the owner to persons other than the person's spouse, civil union partner or de facto partner, regardless of the relationship between the person and the recipient, the Group has identified a range of options to be considered further through the generic tax policy process.

12. Where included assets are transferred on the death of a person, the following two options should be considered:

    - providing rollover only for transfers of certain illiquid assets, i.e. assets not easily realised within an ongoing business (e.g. unlisted shares, active business premises, intangible property and interests in Māori Freehold Land), or
    - providing rollover for all transfers of included assets on death.

13. Providing rollover for illiquid assets on death recognises that these types of assets are difficult and costly to value and are hard to sell or borrow against to fund a tax liability. However, limiting rollover on death to illiquid assets could mean added complexity, because rules would be needed to determine which types of assets would qualify and could create investment biases or horizontal equity issues. Also, in a sense, inheritors have an existing interest in the property through the will or intestacy law.

Example 28: Rollover on death

Wiremu owns an excluded home, a rental property and 100% of the shares in his plumbing business, Pipes Limited. Wiremu dies and leaves the excluded home and rental property to his son and the shares in Pipes Limited to his daughter, who has been working in the business.

As Wiremu's excluded home is excluded from the tax it is not taxed on his death (it would also not be taxed if Wiremu had gifted or sold it). If rollover is limited to transfers of illiquid assets, then the transfer of the shares in Pipes Limited would be ignored and Wiremu's daughter would inherit Wiremu's cost base in the shares. However, because a rental property is not an illiquid asset, the transfer of the rental property would be a realisation event. Wiremu's estate would be required to pay tax on any capital gain (based on a transfer for market value) and Wiremu's son would have a new cost base for the rental property equal to the market value of the rental property at the time of transfer.

If rollover is extended to all transfers of included assets on death, the transfers of both the shares in Pipes Limited and the rental property would be ignored and Wiremu's daughter and son would respectively inherit Wiremu's cost base in the shares and rental property.

14. The Group's preferred view is that rollover should be provided for all transfers of included assets on death.

15. Where included assets are transferred as a gift while a person is still alive, the following two options should be considered:

    - aligning rollover treatment with that provided for transfers of included assets on death (see options above), or

    - providing no rollover (other than for gifts to the person's marriage, civil union or de facto partner as discussed above).

16. There is some merit in aligning the treatment for transfers by gift with the treatment for transfers on death. This is because any distinction in the tax treatment could lead to unnecessarily complex tax planning and economic inefficiencies, such as creating a lock-in bias to retain assets until death. However, a key difference between gifts and transfers on death is that death is not typically an event the taxpayer controls, whereas gifting is. There is a concern that allowing rollover for all gifts to any person (including trusts) at any time gives rise to integrity concerns.

17. The Group's preferred view is that no rollover should be provided for gifts of included assets (other than for gifts to the person's marriage, civil union or de facto partner). This is how most countries treat gifts for their taxation of capital gains.

18. However, where gifts of included assets are made to donee organisations (typically charities) there should be some kind of relief, consistent with the current incentives provided for gifts of money. Under current law, a donation of money to a charity gives rise to a refundable donation tax credit for the person who made the donation. Where included assets are donated to a donee organisation, either:

    - the donation should be treated as a realisation event but the person making the donation should be entitled to a donation tax credit for the donation, or

    - the donation should be ignored for tax purposes, with no tax payable on the capital gain and no donation tax credit provided.

19. The Group's preferred view is that the donation should be ignored for tax purposes. This is more consistent with current donation tax credit rules.

Involuntary events (Insurance and Crown acquisition)

20. Rollover treatment should also apply to certain events where a person involuntarily realises an asset and reinvests the proceeds in a similar replacement asset (within a limited period of time). In these circumstances, taxing the realisation may prevent the person from being able to replace the asset they involuntarily lost. These events are:

    - where an asset is destroyed by a natural disaster or similar event that is outside of the owner's control and insurance proceeds or other compensation is received, and
    - compulsory acquisition of land by the Crown, e.g. under the Public Works Act 1981.

Example 29: Rollover for insurance proceeds

A taxpayer owns a hotel building that is torn down following earthquake damage. The building is insured for replacement cost. The insurance company pays the building owner insurance proceeds of $3 million, which is greater than the taxpayer's $1 million cost base in the building. The taxpayer uses the proceeds to acquire a similar replacement building for $3 million.

If there is no rollover, the taxpayer would be taxed on the $2 million gain.

If rollover treatment applies, the taxpayer would not be taxed on receipt of the insurance proceeds. However, the replacement building would assume the original building's cost base of $1 million. If the taxpayer subsequently sells the replacement building for $5 million they would be taxed on a gain of $4 million.

Business restructures with no change in ownership in substance

21. Rollover treatment should be provided for business transactions that result in a realisation of assets but no change in ownership in substance. Such transactions include:

    - switching between trading structures (e.g. a sole trader decides to incorporate a company and put their business assets into the company in exchange for 100% of the shares)
    - transfers within a wholly-owned group
    - qualifying amalgamations
    - de-mergers (when a company gets split into multiple companies and the owners of the original company receive shares in the new companies)
    - scrip-for-scrip exchanges (a takeover or merger where a shareholder receives shares in the new company in return for shares in their old company).

22. Australia has a set of rollover rules for de-merger and scrip-for-scrip exchanges. Owing to the level of Trans-Tasman trading, consideration should be given to whether these rules should be adopted in New Zealand.

23. In the New Zealand context, this rollover principle should accommodate some Māori collectively owned structures and transactions. In particular, asset transfers from iwi to associated hapū, marae and associated entities (and from hapū or marae to iwi or associated entities) and inter-hapū transactions within the same iwi should qualify for rollover. For example, in the Treaty settlement context, assets are transferred from the Crown to the iwi's post-settlement governance entity (consistent with the Crown's 'large natural groupings' policy) and that entity may later transfer specific assets to hapū or marae (or associated entities on their behalf) that are the customary owner. Tax should not be a barrier to the transfer of such assets within the iwi.

Māori collectively owned assets

24. The Group recognises that taxation of capital gains could create an impediment to a Māori organisation's ability to regain ownership over land lost as a result of historical Crown action. Accordingly, rollover should be provided for transactions relating to recovery by Māori authorities of such land.

25. For example, under Treaty settlement, the Crown can only include in redress land the Crown owns and is ready to dispose of at the time of settlement. When ancestral land is made available by the Crown or becomes available on the open market subsequent to settlement, Māori organisations may need to realise gains by selling land or other assets acquired through their settlement to purchase that ancestral land. Without a rollover rule in this circumstance, a Māori organisation would be subject to tax owing to the arbitrary fact that its preferred ancestral land was not available for the Crown to include in original Treaty settlement redress.

26. In the Treaty settlement context, iwi may not immediately develop the strategic and commercial capabilities needed to align assets with their strategic objectives. The Group notes the Crown's policy of tax indemnities for the transfer of assets from the Crown to iwi under a Treaty settlement and considers that time-limited relief on realised capital gains from settlement assets is also merited.

27. The specific design of rollover rules applicable to Māori collectively owned assets should be developed through further engagement with Māori to ensure the rules achieve the intended policy.

Small business rollover

28. There should be no general rollover treatment for business assets. However, rollover should be provided for small businesses that sell qualifying business assets and reinvest the proceeds in replacement business assets. This is intended to mitigate lock-in for small businesses that may need to upgrade their premises or other business assets as they expand and grow.

29. A small business could be defined as a business with annual turnover of less than $5 million (on an average basis considering the previous five years). A qualifying business asset could be defined as business premises (land and buildings) and intangible property, such as goodwill and intellectual property, that are used to conduct an active business. Shares and leased real property, i.e. commercial offices and residential accommodation that are rented out to a third party, would be excluded.

30. The gains on qualifying business assets would be rolled over to the extent that they were reinvested in replacement active assets within a certain time period, e.g. 12 months. For example, a farmer selling part of their farm and using the proceeds to buy a commercial premises from which they will operate a farm machinery business.

Example 30: Small business rollover

Bakery Limited runs a small bakery out of premises that it owns. The annual turnover for the business is approximately $500,000. Bakery Limited wants to expand but cannot do so in its current premises. Bakery Limited identifies new, larger premises in a similar area. It sells its old premises and uses the sale proceeds to purchase the new premises.

Bakery Limited is a small business. Because it re-invested the proceeds from the sale of its old premises in a new premises it will qualify for the small business rollover treatment, and will not have to pay tax on the gain in value from the sale of its old premises. However, the new premises would assume the old premises' cost base (plus any additional consideration paid for the new premises over and above the proceeds from the sale of the old premises).

Sale of a closely held business upon retirement

31. The Group understands that many business owners fund their retirements by selling their businesses. Another major form of retirement savings is KiwiSaver schemes. In Chapter 5 of Volume I of this report, the Group recommended setting the prescribed investor rates for KiwiSaver schemes at five percentage points lower than the savers' marginal tax rate, so the KiwiSaver tax rates would be 5.5%, 12.5% and 28%.

32. The Group recommends providing a one-off concession by extending these lower KiwiSaver tax rates to the first $500,000 of capital gains made by business owners who sell a closely held active business they have owned for a certain period of time (e.g. 15 years) to retire once they reach retirement age (e.g. 60 years or older). This measure could also potentially apply to younger business owners to the extent that the capital gain they made from selling their business is reinvested into a KiwiSaver scheme.

Example 31: Closely held business on retirement

Gary owns a building business, which he has built up over the past 30 years. When he turns 60, Gary decides to sell the business to one of his senior employees. He sells the business for a capital gain of $1 million. Gary qualifies for the concession for closely held active businesses sold on retirement. Therefore, $500,000 of the capital gain qualifies to be taxed at the lower KiwiSaver tax rates.

If Gary had other income of $70,000 for the income year, this would mean that $500,000 of the capital gain would be taxed at 28% and $500,000 at 33%.

4

How to tax?

General principles

1. Capital gains should be taxed in the same way as any other income. This means capital gains arising from the realisation of included assets will be taxed at a person's marginal tax rate.

Example 32: Application of marginal tax rates

Moana earns $48,000 in wages in a tax year. In the same year, Moana sells some shares and receives a capital gain of $10,000. Her total income this year is $58,000.

Moana's tax liability will be calculated as follows:

$14,000 @ 10.5%	$1,470
$34,000 @ 17.5%	$5,950
$10,000 @ 30%	$3,000
TOTAL TAX	**$10,420**

2. As discussed in Chapter 5 of Volume I, the Group does not recommend that the tax rate for capital gains should be subject to any discount. The Group also does not recommend that income derived from realising included assets should be adjusted for inflation.

Calculation of taxable income

3. Taxable income derived from realising an included asset should be calculated in the same way as other income. In other words, taxable income is calculated by deducting total expenditure from total income, subject to specific timing rules.

Income

4. As discussed in Chapter 3 above, income from included assets will generally be taxed on realisation, i.e. when the asset is sold or otherwise disposed of. The income will be the total sale proceeds or, if the asset is transferred for less than market value (e.g. as a gift), the market value of the included asset at the time of transfer.

Expenditure

5. As a general proposition, expenditure incurred in acquiring an included asset will be deductible at the time of sale. Similarly, costs incurred after acquisition on making improvements[5] to the asset will also be deductible from the sale proceeds.

5 Not including holding costs (see paragraph 6).

Example 33: Calculating net income

Midori owns a holiday home that she purchased for $350,000. After purchasing the home, Midori spent $5,000 on updating the bathroom. Five years later Midori sells the holiday home for $500,000.

In the year that Midori sells the holiday home she will have income of $500,000 and will be allowed a deduction for the acquisition and improvement costs of $355,000, giving her net income of $145,000.

Holding costs

6. Where income is derived from the land, e.g. the land is used as a rental property, costs incurred in connection with holding the land will usually be deductible in the year they are incurred. This includes costs such as interest, rates, insurance and repairs and maintenance expenditure. This treatment should continue for included assets.

Example 34: Holding costs

Jonathan owns a rental property. In the 2024 income year, he pays rates of $2,000, interest of $10,000 and insurance of $1,000 in relation to the property.

Jonathan will be allowed to deduct the rates, interest and insurance expenses from his rental income for the 2024 income year. These costs will not be added to the cost base of the rental property.

7. Current law will continue to be used to identify costs that are costs of acquiring or improving an asset that can reduce a capital gain, versus those holding and other routine costs, e.g. repairs and maintenance expenditure, relating to included assets that are deductible in the year they are incurred.

Land used for private purposes

8. All land, other than the excluded home, should be subject to tax on sale, even if held for private purposes, e.g. as a second home. Expenditure incurred in acquiring or improving land held for private purposes should be deductible on sale. These are costs traditionally considered to be on capital account. However, where land is held for private purposes, costs incurred in connection with holding the land (e.g. interest, rates, insurance and repairs and maintenance costs) should not be deductible because this represents private consumption. These are costs traditionally considered to be on revenue account if gains on sale would have been taxable.

Depreciation

9. Under current law, depreciation deductions are allowed each year for assets that are used to derive assessable income and that are expected to decline in value ('depreciable property'). Where an included asset is depreciable property, depreciation deductions should continue to be allowed. On sale of the asset, the deduction allowed will be the total acquisition and improvement expenditure that has not previously been deducted by way of depreciation. For most depreciable property, this result is the same as the present 'loss-on- sale' rules, however, losses on buildings (not currently deductible) should also be able to be deducted.

Example 35: Depreciable property

Tai has developed software that he uses in his IT business. His development costs were $200,000. He used the software in his business for one year, over which time he claimed $100,000 of depreciation deductions. He then sold the software for $250,000.

In the year of sale, Tai will be taxed on $100,000 of depreciation recovery income (as is the case under current rules) and $50,000 of capital gain ($250,000 – $200,000).

Specific rules

10. There are a number of specific rules in the tax legislation that allow deductions for costs of acquiring or developing specific assets over different periods (e.g. petroleum mining rules). Those rules should be reviewed as part of the generic tax policy process to determine whether they can be rationalised in light of an extension of the taxation of capital gains.

Entering the tax base

11. Where assets already owned by a person enter the tax base, the cost base of those assets for calculating the capital gain on sale will be the value of the assets on the date they entered the base, rather than their original cost. This will occur:

    - when the rules for taxing more capital gains come into force (Valuation Day)
    - when a person changes the use of their assets so that they become included assets (e.g. where a person starts using their excluded home as a rental property), and
    - when a person migrates to New Zealand, bringing included assets with them.

12. Proposed rules for determining the value of assets in these situations are discussed in Chapter 5.

Cash flow assumptions

13. In the case of fungible assets (e.g. shares) where a holding can be acquired or disposed of in several transactions, identifying the cost of a specific item requires assumptions about the identity of the item sold (referred to as a cash flow assumption).

14. In the *Interim Report*, the Group identified some cash flow assumptions (e.g. first in first out, last in last out or average weighted cost) and concluded that further consideration needed to be given to which of those assumptions should be applied for determining the cost of fungible assets if capital gains are taxed more comprehensively. This issue should be considered further as part of the generic tax policy process.

Treatment of losses

Losses generally

15. Where the income from disposing of a capital asset is less than the acquisition and improvement costs relating to that asset, a loss will arise. Consistent with the view that capital gains should be taxed in the same way as other income, generally, losses arising from the disposal of capital assets should be able to be offset against other taxable income.

Example 36: General loss ring-fencing

Kim earns a $50,000 salary each year. She buys a rental property for $400,000. Kim later discovers that the rental property has weathertightness issues and its market value has declined to $370,000. Kim decides to cut her losses and sells the rental property for $370,000, resulting in a $30,000 loss.

Kim should be allowed to use the $30,000 loss to offset part of her $50,000 salary income, so that her net taxable income for the year is only $20,000 (being $50,000 – $30,000).

If there was general loss ring-fencing, Kim would only be allowed to use her $30,000 loss to offset against capital gains and not against her salary income. Instead, she would have to carry forward that loss until she derives a capital gain. If she never derives a capital gain, she will not be able to use that loss at all.

16. However, the Group recognises that allowing capital losses to be deducted from other income comes with risk. Therefore, the Group recommends there should also be some cases where losses cannot be offset against other income (i.e. some losses should be ring-fenced, so they can only be offset against gains from other included assets).

17. In the *Interim Report* the Group recommended that losses on portfolio listed shares and derivatives be ring-fenced to other included assets. This principle should be extended further to any asset where costs to trade are low and economic exposure to the particular asset can easily be regained after crystallising the loss (and which are not already taxed as financial arrangements), such as precious metals or cryptocurrencies.

Example 37: Loss ring-fencing on portfolio listed shares

Sierra directly holds shares in two NZX-listed companies, Alpha Limited and Bravo Limited.

Her Alpha Limited shares have a cost base of $100 and a market value of $120 at the end of the current income year.

Her Bravo Limited shares have a cost base of $100 and a market value of $70 at the end of the current income year.

If losses on portfolio-listed shares were not ring-fenced, Sierra would have an incentive to sell her shares in Bravo Limited before the end of the current income year. She could then repurchase Bravo Limited's shares at the start of the next income year for a similar price. Sierra's economic position would be materially unchanged but she would have been able to crystallise a loss of $30, which she could then use against her other income.

If losses on portfolio-listed shares are ring-fenced, Sierra would only be able to use the $30 loss from the sale of Bravo Limited's shares against gains from other included assets. Her incentive to bring forward the losses from the Bravo Limited shares is therefore greatly reduced.

18. Losses should also be ring-fenced in the following situations:

    - where the cost base or deemed sale price of an asset is determined using a valuation method instead of an arm's-length price (for example, on Valuation Day discussed in Chapter 5)
    - transactions between associated persons
    - situations where taxpayers can choose to apply rollover treatment to gains but not to losses.

19. However, loss ring-fencing is only one possible option for addressing these integrity risks. The Group recommends that further consideration be given through the generic tax policy process to all the options for addressing these integrity risks.

Land used for private purposes

20. Where land, and the buildings on it, is used for private purposes, no losses can be claimed on sale. This is on the basis that such a loss will generally represent private consumption.

Administration

21. The Group acknowledges that taxing more capital gains will increase the record-keeping and compliance costs for taxpayers, particularly for business taxpayers. Further consideration should be given through the generic tax policy process to options for reducing this impact and making tax collection and payment easier. This could include Inland Revenue providing calculators and other guidance to assist taxpayers.

22. Capital gains should be returned in a person's ordinary income tax return in the same way as other income. Whether a person would have to 'file' a tax return would depend on the way in which taxable capital gains are treated administratively.

23. Different asset classes might lend themselves to different administrative treatments. In addition, the Group recognises that some realisation events will not give rise to any cash, and collection rules may need to recognise this.

24. In the *Interim Report*, the Group noted that it could be possible to make use of withholding taxes and third-party information reporting to assist with tax collection. Withholding taxes and third-party information reporting regimes generally involve a trade-off between reducing the compliance burden on the person earning the income and increasing the compliance burden on the payer or reporter. The aim is to reduce compliance costs in the system overall. Requiring a third party to provide information about a transaction, or to withhold tax generally, mitigates the risk of lower compliance rates, which could arise if the payee was required to report their own income.

25. However, increasing information or withholding requirements would increase the obligations on third parties, which should not be underestimated. The Group is very aware of the cumulative effect of recent law changes that have increased the obligations on businesses. In addition, withholding obligations, especially if the rate is too high, can raise obstacles for liquidity. That is especially important to equity markets. Therefore, the Group believes it is important that consultation is undertaken with affected or interested parties before recommendations are made as to how withholding or information provision systems might work in practice. The Group sees this consultation particularly focusing on those who may potentially be asked to provide information or withhold tax to ensure that the impact on those parties can be fully understood. This consultation should focus on the compliance costs that could be imposed on those who would have to withhold tax and how those costs could be minimised.

26. To assist with information provision more generally, information about the value of all assets on Valuation Day should be filed with Inland Revenue within five years and information about increases in the cost base of assets should be filed in the year when those cost are incurred. This will assist taxpayers with accurate record keeping. Taxpayers should disclose to Inland Revenue when they have made use of a rollover concession. All taxpayers should also be required to disclose their IRD numbers at the time of all land purchases and sales.

27. Capital gains should be included in provisional tax calculations in the same way as other income. In some cases, the impact on provisional tax payments of one-off types of income, such as capital gains, has been reduced through recent changes to ensure that most taxpayers will not pay use-of-money interest until their final instalment of provisional tax which is well after the end of the year the income is derived.

Example 38: Provisional tax — standard method

Harris Hoovers Limited is a vacuum sales company that has been in business for 40 years and owns its premises.

Harris Hoovers Limited is a provisional taxpayer that, owing to the steady nature of its income growth, uses the standard method for provisional tax (also known as the uplift method). In the 2024 tax year, Harris Hoovers Limited has residual income tax of $230,000. It has filed its income tax return for the 2024 return prior to its first instalment of provisional tax for the 2025 year. Its first instalment is therefore based on 105% of $230,000. Its instalment is one-third of $241,500 or $80,500. Harris Hoovers Limited also makes its second instalment of provisional tax on the same standard basis and makes another payment of $80,500 on the date of its second instalment.

Prior to Harris Hoovers Limited's third provisional tax instalment date, Laura, the current owner, decides that owing to the surging property market she would be better off selling the building and leasing another premises more suited to the current business needs. Harris Hoovers Limited sells the premises and makes a $700,000 capital gain in the 2025 tax year.

When paying its final provisional tax instalment Harris Hoovers Limited factors in the tax on the capital gain and increases the provisional tax instalment amount by $196,000 making a total payment of $276,500.

After year end Harris Hoovers Limited completes its tax return for the 2025 year. It calculates its tax liability for the year to be $462,500. That is represented by the tax on the capital gain on $196,000 and normal business profits of $266,500. As Harris Hoovers Limited has underpaid its tax for the year it will be subject to use-of-money interest, however, because Harris Hoovers Limited made its first two standard instalments on time and in full it will only be subject to use-of-money interest from the date of the final instalment of provisional tax on the underpayment of $25,000.

In calculating its 2026 provisional tax Harris Hoovers Limited decides to estimate its provisional tax. Because Harris Hoover Limited's income for the 2025 income year included the capital gain, using the standard method, and paying based on 105% of the 2025 residual income tax, would result in an overpayment as it is not likely to make any further capital gains.

Example 39: Provisional tax – estimate method

Libby is an accountant. In the 2031 income year she earns a salary of $80,000, which has pay as you earn (PAYE) deducted. Libby owns a rental property, which she purchased in 2025 for $600,000. In July 2030, Libby sells her rental property for $800,000.

Libby has made a $200,000 capital gain from selling her rental property, which will be taxed at 33% (Libby is already on the top marginal tax rate with her $80,000 salary). Libby already pays provisional tax on her rental income because her residual income tax liability is more than $2,500.

Libby estimates her provisional tax. She will now also be required to pay an additional $66,000 of provisional tax. Libby will be required to pay one third of the tax due on each instalment date, being 28 August 2030, 15 January 2031 and 7 May 2031. If Libby does not pay the correct amount of tax on each instalment date, use-of-money interest will be imposed.

Social policy

28. Current rules for some social policy schemes refer to a person's 'income' under the Income Tax Act 2007 when calculating a person's entitlements and obligations (e.g. a person's Working for Families tax credits entitlement, student loan repayment obligation or child support calculated under the formula assessment). Income for this purpose currently includes some capital gains, e.g. capital gains arising from the sale of land that is subject to the bright-line test.

29. Capital gains should be treated as ordinary income. This means that capital gains should be included in the calculations for social policy schemes that rely on income under the Income Tax Act 2007 for the calculations. There is no obvious reason for excluding capital gains in these cases.

30. The Group also notes that revenue losses are currently excluded from the calculations.[6] Allowing capital losses to affect entitlements and obligations would be a departure from the existing rules that ignore losses. Consequently, for the same reasons that revenue losses are currently ignored, capital losses should also be ignored.

6 With the exception of the child support formula assessment that does not currently ignore revenue losses. However, the Group notes the previous Government proposed more closely aligning the definition of income for child support purposes to that which is used for Working for Families tax credits and determining student loan repayments. This would include disregarding losses for the calculation in the formula assessment.

5

Transitional rules

Introduction

1. This Chapter considers the rules that should apply where assets already owned by a person enter or exit the tax base. This will occur when:

   - the rules for taxing more capital gains come into force (Valuation Day)
   - a person changes the use of their assets so that they become included assets, e.g. where a person starts using their excluded home as a rental property, or stop being included assets, e.g. where a car used for business purposes changes to a personal-use asset, and
   - a person migrates to or from New Zealand, bringing included assets with them.

Valuation Day

2. The rules for taxing more capital gains would apply to gains and losses that arise after the implementation date ('Valuation Day'). This approach would require taxpayers to:

   - determine the value of the asset as of Valuation Day (a number of valuation options would be available), and
   - calculate the increase or decrease in value from Valuation Day when the asset is sold or disposed of (special rules may apply to limit paper gains and/or losses[7]).

3. The rules for Valuation Day should provide taxpayers a choice between simplicity and accuracy and provide different options for different types of assets. 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 and unreasonable compliance costs on taxpayers. 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.

Flexible valuation rules

4. The legislation should require that the cost base for included assets will be their value on Valuation Day.[8] This should be supplemented by Inland Revenue guidance on appropriate valuation methods. This approach is consistent with other scenarios where the tax legislation requires a value and allows greater flexibility for taxpayers to pick the most appropriate valuation method for their asset.

5. This guidance should provide taxpayers with safe-harbour valuation methodologies that Inland Revenue will accept and outline what information the taxpayer should file and retain to support their valuation. This guidance should be prepared at the same time as the draft legislation for the new rules to assist with certainty for taxpayers.

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7 A paper gain can occur when the value on Valuation Day is lower than an asset's cost price but the asset then sells for a higher price. These gains are often artificial and do not represent an actual or economic gain. Conversely, a paper loss can occur when the value on Valuation Day is higher than an asset's sale price.

8 Including improvement costs incurred after Valuation Day.

6. Inland Revenue should also provide calculators and publish other material to assist taxpayers in determining the value of their included assets. For example, to reduce compliance costs for owners of NZX-listed and ASX-listed shares, Inland Revenue could publish information about the relevant valuations of these shares on Valuation Day.

7. Property that is already revenue account property will not need to be valued on Valuation Day as this property is already subject to tax on sale no matter when it was acquired. Depreciable property would also not need to be valued on Valuation Day, unless the owner wanted to establish a Valuation Day value higher than the tax book value.

Valuation options

8. Inland Revenue guidance should provide several different valuation methods for various types of assets. Options could include but would not be limited to:

    - **Actual value** – this would typically only apply to assets that have easily obtainable values such as listed shares,[9]
    - **Arm's-length valuation** – this would generally be the most accurate, particularly where the actual value is not available, but will require higher compliance costs as a result of engaging professional valuers.

9. For real property (i.e. land) options could include:

    - **Comparison with similar properties** – this could be done on a case-by-case basis or using an algorithm already commonly available (e.g. Quotable Value (QV) valuations).
    - **Ratings valuations (RV)** – this is easily obtainable but may be inaccurate depending on when it was last updated. A choice between the RV before and after Valuation Day may be more accurate in some cases.

10. For other major asset classes, the Government should consider additional valuation methods. For example:

    - **International Financial Reporting Standards (IFRS)** rules require assets to be valued at fair market values. Where these rules are used to determine the value of assets over the period that includes Valuation Day, that value could be the value adopted on Valuation Day.
    - If shares are listed in New Zealand, their value on Valuation Day could be **the volume weighted average price** for a certain period (such as the five days) prior to Valuation Day. If the shares are not listed in New Zealand but are listed on one or more overseas recognised exchanges, the foreign value will need to be converted to its New Zealand dollar equivalent.

Default valuation methods

11. The Government should consider what the most appropriate default valuation option is for each kind of asset for taxpayers who do not value their assets under another method. This should include approved simplified methods of valuation for various asset classes.

12. For example, a straight-line method, where the gain or loss is pro-rated over the time the asset is held, could be the default option. Under the straight-line method, at the time an asset is sold, the owner would determine the total gain on sale derived over the whole period of ownership and then determine what proportion of that gain was derived after Valuation Day.

9 Although, where a person has a large interest in a listed company, the value stated on the stock exchange may not be an accurate measure of the value of that interest.

13. Where a person has no record of the original cost, the cost will be treated as being nil.

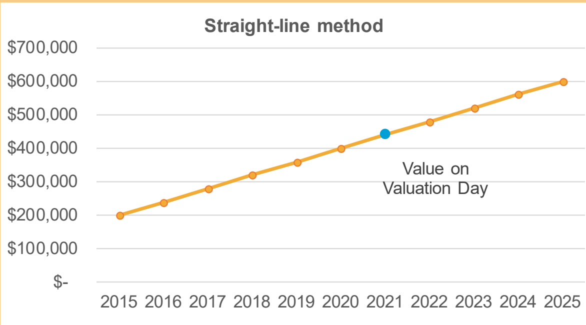
14. The application of the straight-line method is illustrated by the following example.

Example 40: Straight-line method

John purchased a small trucking business on 1 April 2015 for $200,000. On 31 March 2025, John sells the business to Paul for $600,000 (i.e. a $400,000 gain).

As a result of the extension of the taxation of capital gains, John will have to pay tax on the capital gain he has derived since Valuation Day (1 April 2021) from the sale of the business (i.e. for the last four years he has owned the business).

Applying a straight-line approach, John will have to pay tax on 4/10th of the gain on sale (i.e. $160,000).



Calculating capital gains or losses after Valuation Day

15. Where assets held prior to Valuation Day are disposed of, the 'median rule' should apply to calculate the capital gain or loss that arises. The median rule is not a valuation method (as described above). Instead, its purpose is to smooth capital gains and prevent taxpayers from being subject to tax on artificial paper gains or losses. Artificial paper gains or losses arise only owing to the value on Valuation Day being lower or higher than the cost price and the sale price.

16. Under the median rule, the amount to be deducted from the sale price would be the median, i.e. the middle value, of:

    - the actual cost,[10] including improvement costs
    - the value on Valuation Day, plus improvement costs, and
    - the sale price.

17. This means the capital gain or loss will be calculated using the following formula:

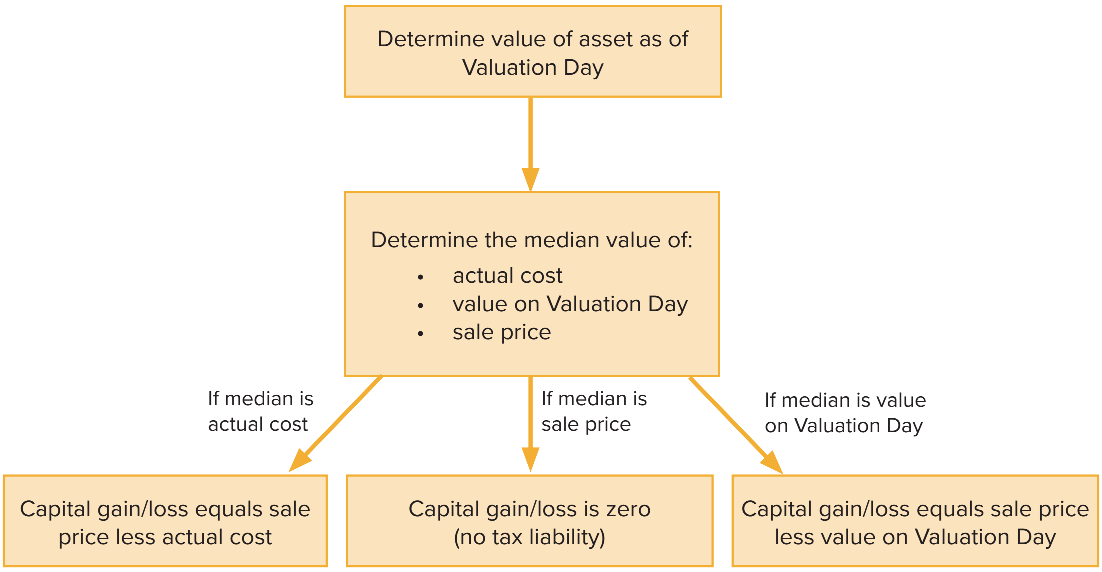
    Capital gain/loss = the sale price – the median value

18. The median rule will give the same answer as calculating the change in asset value since Valuation Day when an asset is consistently appreciating or depreciating. This is expected to be the situation in the majority of cases. It will only have effect when the value of an asset fluctuates between the original purchase price, the value on Valuation Day and the sale price.

19. The application of the median rule can be broken down into the following steps shown in figure 5.1.

10 Where a taxpayer has no record of their actual cost, it will be treated as nil.

Figure 5.1: Application of the median rule



Example 41: Steadily appreciating asset

In 2014 Ben bought a rental property for $500,000. He obtained a QV valuation for Valuation Day of $650,000. Ben sold the property three years after Valuation Day for $800,000.

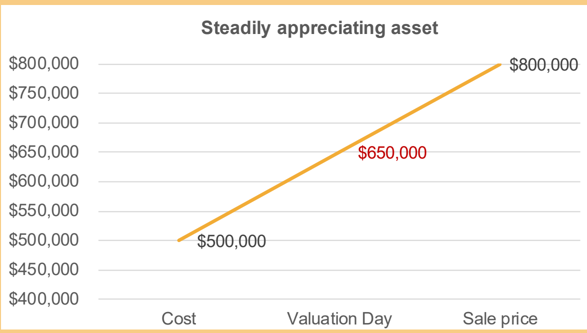
Applying the median rule:

Cost = $500,000

Valuation Day value = $650,000

Sale price = $800,000

The median value is $650,000. Therefore, Ben is able to deduct $650,000 from the sale price of $800,000, giving rise to a $150,000 taxable gain. In this situation, the median rule does not change the outcome.



Example 42: Steadily depreciating asset

In 1995, Paul purchased 100 shares for $1,000 in an unlisted New Zealand company selling analog cameras. Since the introduction of digital cameras, the value of Paul's shares has been slowly declining. On Valuation Day, Paul's shares were valued at $600 and he eventually sold the shares two years after Valuation Day for $200.

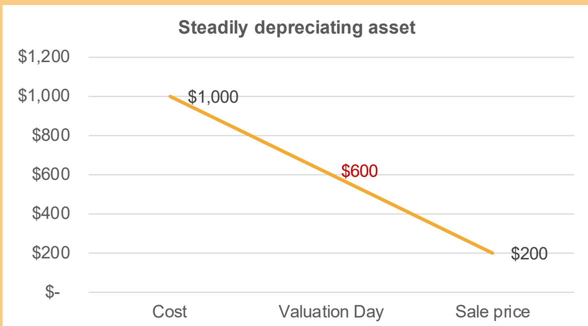
Applying the median rule:

Cost = $1,000

Valuation Day value = $600

Sale price = $200

The median value is $600. Therefore, Paul can deduct $600 from the sale price of $200, giving rise to a $400 taxable loss. In this situation, the median rule does not change the outcome.



Example 43: Fluctuating asset value – paper gains

In 2014 Scott bought a rental property for $500,000. On Valuation Day the property was valued at $450,000. Scott sold the property six years after Valuation Day for $850,000.

Applying the median rule:

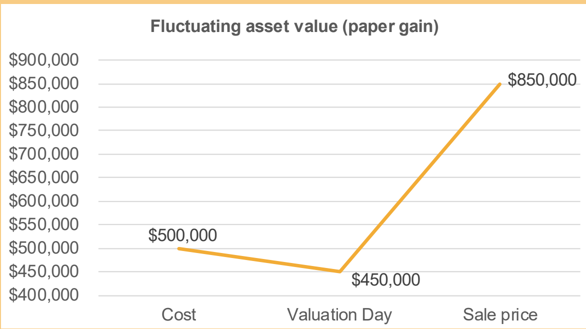
Cost = $500,000

Valuation Day value = $450,000

Sale price = $850,000

The median value is $500,000. Therefore, Scott is able to deduct $500,000 from the sale price of $850,000, giving rise to a $350,000 taxable gain.

Without the median rule, Scott would have a taxable gain of $400,000 (i.e. sale price of $850,000 – price on Valuation Day of $450,000) despite only making a gain of $350,000 over the whole period he owned the property.



Example 44: Fluctuating asset value – paper loss

In 2010 Claire bought some shares for $500,000 in an unlisted company. On Valuation Day the shares had a value of $800,000. Claire sold the shares two years after Valuation Day for $700,000.

Applying the median rule:

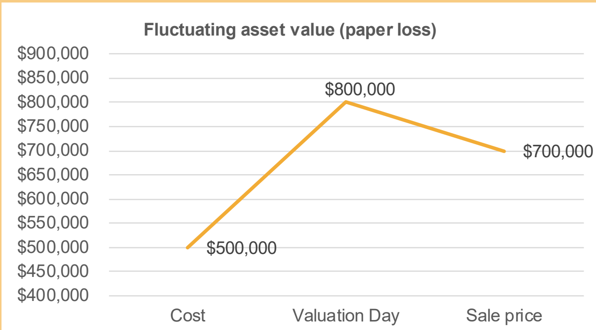
Cost = $500,000

Valuation Day value = $800,000

Sale price = $700,000

The median value is $700,000, which is also the sale price. Therefore, Claire does not have a capital gain or loss.

Without the median rule, Claire would have a loss of $100,000 (i.e. sale price of $700,000 – value on Valuation Day of $800,000) despite making a gain of $200,000 over the whole period she owned the shares.



Example 45: Costs incurred after Valuation day

Marama owns a building damaged by an earthquake. The building was purchased in 2016 (before the earthquake) for $8 million. The value of the building immediately before the earthquake was $12 million. The earthquake damage reduced the value to $9 million.

Before Valuation Day, Marama pays $3 million to repair the building and bring it up to code, which restores the value to $12 million. This is the Valuation Day value of the building.

Marama sells the building five years after Valuation Day for $14 million.

In applying the median rule, the cost of the building should also be increased by the $3 million of remedial costs, resulting in a cost of $11 million (i.e. $8 million purchase price plus $3 million remedial costs). Applying the median rule:

Cost = $11 million

Valuation Day value = $12 million

Sale price = $14 million

The median value is $12 million. Therefore, Marama is able to deduct $12 million from the sale price of $14 million, giving rise to a $2 million taxable gain.

If Marama carried out the repairs to the building after Valuation Day the result should be the same. The repair costs ($3 million) would be added to the cost of the building ($8 million) and the value on Valuation Day ($9 million):

Cost = $11 million

Valuation Day value = $12 million

Sale price = $14 million

The median value would still be $12 million, resulting in a $2 million taxable gain.

Applying the median rule to listed shares

20. The median rule should be applied to all affected assets, except for listed shares. Listed shares are subject to market pricing so the taxpayer has no ability to manipulate the value on Valuation Day.

21. If the median rule is used for listed shares, it would incentivise shareholders to sell all shares that have increased in value before Valuation Day and then buy them back to ensure they have a certain cost base if the shares then lose value. This would impose compliance costs without achieving any economic benefit. In not applying the median rule, however, paper gains may be taxed and paper losses allowed in some circumstances.

Example 46: Listed shares that have increased in price

In 2018 Yul purchased shares in A Co for $20 each. On Valuation Day the shares had risen in value to $50 each. If the median rule applied Yul would be incentivised to sell and buy back the shares because:

- if the shares later drop in value (e.g. to $30) no loss would be available under the median rule, as it is only a 'paper loss', the shares are still worth more than when Yul bought them. The median value would have been $30, so there would be no loss. If, however, Yul sold and bought back his shares on Valuation Day, he would be able to access a loss when he later sold them (Valuation Day value of $50 – sale price of $30 = a loss of $20)
- conversely, if the shares later increased in value (e.g. to $60) Yul would be taxable on the gain ($60 – $50 = $10) which would be the same result as under the median rule ($50 is the median of $20, $50 and $60).

Example 47: Listed shares that have decreased in price

In 2018 Yul purchased shares in A Co for $20 each. On Valuation Day the shares had decreased in value to $10 each. If the median rule applied Yul would be better off holding the shares (i.e. not selling and buying back on Valuation Day).

If the shares later drop in value (e.g. to $7) a loss of $3 is available with or without the median rule.

If the shares increase to $13 however a 'paper gain' of $3 would be taxable, without the median rule, while there would be no taxable gain with the median rule.

If the shares increase to $25 a gain of $15 would be taxable, $10 of which is a paper gain, without the median rule or $5 taxable gain with the median rule.

22. Further, a managed fund would not want to apply the median rule as it would cause equity concerns between investors who bought shares before and after Valuation Day.

Example 48: Listed shares owned by a fund

A managed fund bought shares before Valuation Day for $1,000, which have increased to $1,500 on Valuation Day. Over the next month the shares decline to $1,200 but continue to be held by the fund.

On Valuation Day Ilena buys 1% of the fund for $15 and sells out of the fund one month later for $12.

Ilena expects to receive a $3 loss allocation from the fund for tax purposes. However, if the fund has applied the median rule, the Valuation Day value is $1,200, so there would be no taxable gain or loss that can be attributed to Ilena.

23. To avoid shareholders selling and buying back any shares that have increased in value on Valuation Day and the equity concerns that could arise in managed funds, the median rule should not be used for listed shares.

Change of use

24. Where a person completely changes the use of their assets, for example, from an excluded home to a rental property, or from being a business asset to a personal-use asset, apportionment will be necessary to ensure that the capital gain or loss arising for the period when the asset was used for income-earning purposes is captured.

25. For real property (i.e. land), where there is a change of use, the capital gain or loss on sale will need to be apportioned, either:

- based on the time that the person used the asset as an excluded asset (i.e. an excluded home or personal-use asset) compared with the total time they owned the asset, or
- based on the actual increase in value while the asset was used as an excluded asset (with the same valuation options as discussed above).

Example 49: Residential to rental

Peter purchases a property in 2022 for $500,000. He uses the property as his residence. In 2027, Peter moves out of the property and uses it as a residential rental property. At the time of the change of use, the property is valued at $600,000. In 2030, Peter sells the property for $700,000.

When Peter sells the property, he has a net gain of $200,000.

Peter can choose to pay tax on 3/8 of the net gain (being $75,000) because he used the property for income-earning purposes for three of the eight years he owned it.

Alternatively, Peter can choose to calculate the actual increase in value that is attributable to the time that Peter used the property as a residential rental property (i.e. $100,000, being $700,000 – $600,000) and pay tax on that gain.

The remaining gain on sale will not be taxable because it relates to the time that Peter used the property as his excluded home

Example 50: Rental to residential

Wang Fang purchases a property in 2030 for $400,000. She uses the property as a residential rental property. In 2034, Wang Fang decides to move into the property and uses it as her main residence. At the time of the change of use, the property is valued at $550,000. In 2037, Wang Fang sells the property for $675,000.

When Wang Fang sells the property, she has a net gain of $275,000.

Wang Fang can choose to pay tax on 4/7 of the net gain ($157,143), because she used the property as a rental property for four of the seven years she owned it.

Alternatively, Wang Fang can pay tax on the actual gain relating to the time the property was used as a rental property, being $150,000 (i.e. $550,000 – $400,000).

The remaining net gain will not be taxable because it relates to the period when Wang Fang used the property as her excluded home.

26. The same rules will apply where a person dies and the property is rented out while the estate is wound up.

Example 51: Change of use on death

Brian owned a property in Christchurch where he lived since he purchased it in 2022. He purchased the property for $600,000. In 2030 Brian dies. While winding up the estate, Brian's executors decide to rent the property out. At the time of the change of use, the property is valued at $900,000. The property is rented until it is sold in 2032 for $1 million.

When Brian's estate sells the property, they have a net gain of $400,000.

Brian's estate can choose to pay tax on 2/10 of the total gain (i.e. $80,000), because the property was used for income-earning purposes for two of the 10 years the property was owned by Brian and his estate.

Alternatively, Brian's estate can choose to pay tax on the actual gain attributable to the time the property was used as a rental property (being $100,000).

The remaining gain on sale will not be taxed because it relates to the time Brian used the property as his excluded home.

27. Where there is a temporary change of use as a result of a person moving for work purposes, or going overseas for a short period, the change of use will be ignored for four years. However, a person will still only be allowed one excluded home at any one time. If, during that period, a person owns another property that is their excluded home (either in New Zealand or overseas), then the change of use will give rise to a requirement to apportion on sale.

Example 52: Moving overseas

Michael and Kath own a property in Dunedin, which they purchased in 2030 for $300,000. In 2034, Michael and Kath decide to go overseas on their OE. They are gone for two years and during this time they rent out the property.

As Michael and Kath have been absent for less than four years and have not purchased another property that has been their excluded home during this time, the change of use will be ignored and they will not be required to pay any tax when they later sell the property.

Example 53: Empty home

Bill owns a property in New Zealand which he occupied as his residence since he purchased it in 2022 for $675,000. In 2025 Bill decides to move overseas for work. He intends to return to the property and does not want anyone to damage it while he is away, so leaves his property empty while he is away. He is away for 3½ years.

Bill has been absent for less than four years. While overseas, Bill stayed in rented accommodation. Therefore, the change of use will be ignored and Bill will not be required to pay any tax when he later sells the property.

Example 54: Moving for work reasons

Donald and Lucy occupy a home in Auckland, which they purchased in 2030 for $450,000. In 2034, they temporarily move to Wellington for work reasons. Donald and Lucy purchase an apartment in Wellington where they live while they are there but decide to keep their Auckland home while they are away and rent it out. At that time, the Auckland home is valued at $600,000.

In 2037 Donald and Lucy sell their Wellington apartment and move back into their Auckland home. At this time, the Auckland property is valued at $950,000. Donald and Lucy live in their home until 2041 when it is sold for $1.1 million.

When Donald and Lucy sell their Auckland home they have a net gain of $650,000.

Because Donald and Lucy owned another property that they occupied as their excluded home during the period they were away, they will have to pay tax on the sale of their Auckland home. Donald and Lucy can choose to pay tax on 3/11 of the net gain (i.e. $177,273), because they used the property for income-earning purposes for three of the 11 years they owed it.

Alternatively, they can choose to pay tax on the actual gain that arose when the property was used as a rental property (i.e. $350,000).

The remaining net gain will not be taxable because it is attributable to the time when Donald and Lucy used the property as their excluded home.

28. Rules for apportionment for other property should be considered as part of the generic tax policy process. In particular, consideration needs to be given to the interaction with the current depreciation rules.

Migration

29. The Group has considered the tax consequences of included assets entering and leaving the New Zealand tax base when an asset owner becomes ('immigrates') or ceases to be ('emigrates') New Zealand tax resident.

30. As a preliminary point, under the current tax residence rules, it can be hard in some cases to determine exactly when tax residence ends or begins. The individual tax residence rules may therefore need to be amended, or applied in a modified form, for the rules proposed below.

Emigration

31. When a taxpayer migrates, assets they hold may leave the New Zealand tax base. Included assets should be deemed to be sold for market value immediately before the taxpayer migrates ('the deemed disposal rule'). This ensures taxpayers cannot avoid a realisation-based tax on capital gains by ceasing their tax residency before disposing of their included assets. The tax will be payable in the year the taxpayer migrates.

Example 55: Emigration while holding New Zealand shares

Mahutu is a New Zealand tax resident. He holds some New Zealand shares that he bought for $100,000 in 2022.

Mahutu decides to leave New Zealand and move to the United Kingdom. He ceases to be tax resident in New Zealand in the 2027/28 income year. On the day his tax residence ends, the shares are worth $180,000.

Mahutu is treated for New Zealand tax purposes as having derived a capital gain of $80,000 (being $180,000 – $100,000).

32. For similar reasons, there should also be a taxable disposal when certain assets are transferred to a non-resident person. Rollover on death or gifting that may otherwise apply to such a transfer should not be provided if it results in the accrued gain or loss on the asset never being taxed in New Zealand.

33. The deemed disposal rule should not apply to assets that are taxed on accrual, such as the underlying investments in KiwiSaver funds, which are attributed to the investors, and other PIEs (discussed further in Chapter 9) and foreign shares that are taxed under the FDR method under the FIF regime (discussed further in Chapter 8). The deemed disposal rule should also not apply to included assets that are generally taxable for non-residents, such as New Zealand land and assets forming part of the business property of a New Zealand permanent establishment (discussed further in Chapter 6).

34. As such, the deemed disposal rule would not apply to most assets held by many taxpayers, including the excluded home, rental properties, KiwiSaver and PIE investments (which are not usually taxed on redemption) and foreign shares subject to the FDR method under the FIF regime. However, the rule would apply to New Zealand shares and Australian listed shares and possibly to intangible property, if it is not attributable to a New Zealand permanent establishment.

Example 56: Emigration while holding KiwiSaver and a farm

Chi is a New Zealand tax resident. She has a KiwiSaver account with $30,000 and owns a New Zealand farm. Chi decides to leave New Zealand and move to Australia. She ceases to be tax resident in New Zealand on 31 January 2022.

Chi will not be treated as having disposed of her KiwiSaver investment or farm on emigration. Her farm, including assets attributable to that farm, such as goodwill, remains in the New Zealand tax base and her KiwiSaver funds will have been taxed on accrual.

35. The *Interim Report* suggested the possibility of making this deemed disposal optional, as is the case in Australia. The Group is now of the view that this would not be appropriate because it is likely to lead to revenue leakage. However, the Group is conscious that a deemed disposal could cause compliance cost and cash flow issues for temporary emigrants, taxpayers holding illiquid assets and taxpayers with modest unrealised gains.

36. Where a taxpayer emigrates for a short period but becomes tax resident again, assets they hold would leave and re-enter New Zealand's tax base. A deemed disposal on emigration would therefore be an unnecessary compliance burden for the taxpayer.

37. A taxpayer should be allowed to 'unwind' a deemed disposal on emigration if they subsequently return to New Zealand holding the same assets in the same capacity. Unwinding a deemed disposal should unwind both the core tax liability, which should already have been paid, and any interest and penalties resulting from the liability if there has been an underpayment. Because the taxpayer has paid the tax before the unwind and that results in an overpayment, the ordinary rules for excess tax should apply. The taxpayer may be entitled to use-of-money interest and a refund, if the tax is not applied to satisfy another tax liability. As the unwind option is aimed at temporary emigrants, it should be subject to a time limit.

Example 57: Temporary emigration

Hera is a New Zealand tax resident, with a 33% marginal tax rate. She holds some New Zealand shares that she bought for $10,000 in 2021.

Hera decides to take up an employment opportunity in Australia and ceases to be tax resident in New Zealand from the 2025 income year. On the day her tax residence ends, the shares are worth $70,000. Under the deemed disposal rule, Hera is treated as having realised a gain of $60,000 (being $70,000 – $10,000) and pays tax of $19,800 (33% × $60,000).

After working in Australia for a few years, Hera decides to return to New Zealand and becomes tax resident again in the 2028 income year. She has not sold any of her shares, which have now fallen in value to $50,000.

Hera elects to unwind the deemed disposal of her shares in the 2025 income year, so the shares assume their original cost base of $10,000. As Hera has no outstanding tax liabilities, she is entitled to a tax refund of $20,000 and interest on that refund.

38. Where a taxpayer emigrates holding certain illiquid assets, for example, an unlisted business with assets not attributable to a New Zealand permanent establishment, a deemed disposal of the illiquid assets could cause cash flow and valuation difficulties. In such cases, the deemed disposal rule should still apply on migration to crystallise New Zealand's taxing rights. However, taxpayers should be allowed to defer payment of the tax for a period. Conditions of deferral, including the payment of a security bond, will be required to ensure New Zealand's tax base is protected. These conditions should be decided following consultation with taxpayers to ensure they are workable.

Example 58: Certain illiquid assets

Terry is a New Zealand tax resident, with a 33% marginal tax rate. He holds all the unlisted shares in his online consultancy business, which have a cost base of $50,000. Terry's shares are not attributable to a permanent establishment in New Zealand.

Terry decides to move overseas, since he can work remotely and has built up a client base for his business. He ceases to be tax resident in New Zealand from the 2030 year. His shares are worth $170,000 at the time he ceases tax residence.

Under the deemed disposal rule, Terry is treated as having realised a gain of $120,000 ($170,000 – $50,000) and is liable to pay tax of $39,600 (33% × $120,000). However, because his shares are unlisted, provided he satisfies any relevant conditions, and pays the required security bond, he can defer payment of the tax.

39. There should also be a *de minimis* threshold, so that a deemed disposal would be ignored if it resulted in capital gains that, in aggregate, fall below a certain amount. As people can become non-resident and resident again multiple times in their lives, the *de minimis* should be set at a modest level so that it is unlikely to be used to avoid tax on capital gains. A threshold of $15,000 of capital gains would be appropriate. This translates to approximately $5,000 of tax for a taxpayer on a 33% marginal tax rate.

Example 59: *De minimis* threshold

Kara is a New Zealand tax resident. She holds a portfolio of listed New Zealand shares that have a total cost base of $50,000. She also has a KiwiSaver investment of $30,000 and owns a New Zealand rental property worth $500,000.

In 2023, Kara decides to move to Australia to be closer to family. On the day Kara ceases to be New Zealand tax resident, the total market value of her share portfolio is $60,000.

If the deemed disposal rule applied, Kara would be treated as having realised a gain of $10,000 ($60,000 – $50,000). However, because this gain is under the $15,000 *de minimis* threshold her gain is ignored and she is not liable to pay any tax. Kara's KiwiSaver investment and rental property are not taken into account for the *de minimis*.

Immigration

40. If a person immigrates to New Zealand holding an included asset that they acquired while non-resident, the asset may enter the New Zealand tax base at the time the person becomes tax resident in New Zealand. In such cases, the person should be treated as if they disposed of and re-acquired their assets for market value at the time they become New Zealand tax resident (or, for transitional residents holding foreign assets, at the time they become a New Zealand tax resident who is not a transitional resident).

41. This approach would ensure that any capital gain (or loss) accruing when the person was non-resident is not taxed in New Zealand. This is also consistent with New Zealand's existing tax treaties and is required by some of the treaties, including the Australian treaty.

Example 60: Immigration from Australia

In 2031, Tom, an Australian tax resident, buys some Australian shares for $100.

In 2033, Tom migrates to New Zealand. Tom ceases to be resident in Australia on the same day he becomes resident in New Zealand. The value of his shares is $150.

In 2040, Tom sells the shares for their market value of $210. His actual capital gain is $110.

The tax consequences for Tom will be:

- In 2033, Tom is treated for Australian tax purposes as having a capital gain of $50 (being $150 – $100).
- In 2040, Tom will be treated for New Zealand tax purposes as having derived a capital gain of $60 (being $210 – $150). This is consistent with the New Zealand/Australia double tax agreement.

Overall, Tom has been taxed on his actual capital gain of $110 ($50 of which was taxed in Australia and $60 of which was taxed in New Zealand).

42. This does not apply to assets that have always been in the New Zealand tax base, such as New Zealand land and assets of a New Zealand permanent establishment. The cost base of these assets will be determined under normal rules (usually original cost).

6

Who will be taxed?

1. All New Zealand resident individuals and entities should be taxed on the realisation of included assets. This Chapter discusses some specific rules that will apply.

Companies

2. Assets held by companies should, in most cases, be subject to the extension of the taxation of capital gains in the same way as assets held by individuals.

3. However, specific rules are needed for transactions within groups of companies. Those specific rules are discussed further in Chapter 10.

Qualifying companies

4. The qualifying company regime applies to companies that have five or fewer natural person shareholders and allows the company to distribute capital gains tax free without liquidating. The qualifying company regime was replaced by the look-through company (LTC) regime from 1 April 2011. However, existing qualifying companies were allowed to continue.

5. If the taxation of capital gains is extended, this regime should be repealed because all capital gains will be subject to tax. However, a transitional regime will be necessary to allow current qualifying companies to pass out all capital gains (realised and unrealised) that were derived prior to the introduction of the new rules.

Trusts

6. As with companies, assets held by a trust should be subject to the extension of the taxation of capital gains in the same way as it applies to assets held by individuals.

7. The current rules should continue to apply, so that income from the disposal of included assets by a trust will be taxable income for the:

    - beneficiary, if the income is distributed as beneficiary income, or
    - trustee if the income is not distributed.

8. Where a trust makes distributions other than of beneficiary income:

    - distributions from complying trusts would continue to be tax free to the beneficiary in all cases
    - distributions from non-complying trusts would continue to be taxable income of the beneficiary, unless the distribution is sourced from the corpus of the trust,[11] and
    - distributions from foreign trusts would continue to be tax free if they are sourced from corpus or capital gains derived prior to the introduction of an extension of the taxation of capital gains, however, they would be taxable income if sourced from income whenever derived or from capital gains derived after the introduction of an extension of the taxation of capital gains.

11 The corpus of a trust is the amount that has been settled on the trust (in money or money's worth) by the settlors.

9. A distribution from a trust to a beneficiary, and a settlement on a trust, is essentially a gift. Therefore, the tax consequences of distributions and settlements that consist of included assets will depend on the ultimate decisions made regarding rollover treatment for gifts. If rollover treatment is restricted to gifts made to a spouse, civil union partner or de facto partner, then it will not apply to distributions or settlements and they will be treated as realisation events (even if the beneficiary who ultimately becomes entitled to the asset is the spouse, civil union partner or de facto partner of the settlor). However, if it is decided that rollover for gifts will be broader, then rollover treatment may apply to distributions and settlements and these transfers would then be ignored.

10. As for individuals, trusts can enter and exit the New Zealand tax base depending on the residence of the settlor. As part of the generic tax policy process, consideration should be given to whether specific rules are needed to deem a trust to dispose of assets if the settlors migrate offshore.

Avoidance

11. Consideration should be given to anti-avoidance rules for trusts to protect the integrity of the tax system. Trusts can hold assets for many years for the benefit of several generations of beneficiaries and can be used to avoid realisation events. For example, it is possible to change the trustees of a trust, or the owner of a corporate trustee of a trust, so that it is controlled by someone else, rather than selling the underlying assets owned by the trust. The current law already contains a rule to treat this type of transaction as a deemed disposal of land, if the effect of the change is to defeat the application of the bright-line rule. A similar rule should be enacted for capital gains purposes.

Partnerships and look-through companies

12. Under an extension of the taxation of capital gains, the realisation of an included asset by a partnership or LTC will be subject to tax. Income and expenditure relating to the included asset will be allocated to the partners or shareholders in the same way as for any other income or expenditure.

13. Under current rules, a partner or shareholder is treated as holding property that the partnership or LTC holds, in proportion to their partnership share or effective look-through interest. Therefore, the disposal of a partnership interest or a share in an LTC is treated as a sale by the partner or shareholder of their share of the underlying assets of the partnership or LTC. This should continue to be the case under an extension of the taxation of capital gains. This deemed disposal will be a realisation event, which will give rise to taxable income for the partner or shareholder.

14. There are currently a number of *de minimis* rules in the partnership and LTC rules that allow gains and losses on disposal of partnership or LTC interest to be ignored. The continued appropriateness of these provisions in the context of an extended tax on capital gains on sale will need to be considered as part of the generic tax policy process.

15. The fact that the disposal of a partnership interest or share in an LTC is treated as a disposal of the underlying assets also means that new partners can have a different cost base for their share of the assets than other partners. This gives rise to record keeping and calculation complications. This issue already exists for depreciated and other taxable property. However, the proposed extension of the taxation of capital gains will exacerbate this issue. Consideration should be given to whether a solution to this issue can be identified as part of the generic tax policy process.

16. Under current law:

- a contribution of an asset to a partnership in exchange for a partnership interest or an increased interest, is treated as a sale of the entire asset contributed (despite the contributing partner having an interest in the asset as a partner), and
- a distribution of a partnership asset *in specie*[12] is treated as a 100% sale for market value.

17. The same approach should apply to assets to be included in the new rules. However, rollover treatment may apply to such a transaction in some cases.

Non-residents

18. As a general principle, the current rules, which tax non-residents on income sourced from New Zealand, should also apply for an extension of the taxation of capital gains. In particular, non-residents should be taxed on the realisation of:

- interests in New Zealand land, broadly defined to include physical resources, e.g. minerals
- interests in New Zealand land-rich companies, being companies that derive more than half of their value, directly or indirectly, from New Zealand land, unless the non-resident holds less than 10% of a listed company, and
- assets forming part of the business property of a New Zealand permanent establishment.

19. However, non-residents should not be taxed on the realisation of other included assets located in New Zealand. It can be difficult to determine whether intangible property and shares are located in New Zealand when they are realised and to enforce such tax liabilities. Taxing other assets would also be inconsistent with some of New Zealand's tax treaties and the approach that many other countries with broad capital gains taxes take to taxing non-residents on capital gains.

12 An *in specie* distribution is a distribution of assets rather than cash.

7

Specific regimes – Taxation of New Zealand shares (non-corporate groups)

1. The taxation of shares in New Zealand companies could potentially differ depending on the nature of the interest. There are three options for taxing interests of less than 10% in listed New Zealand companies:
   - they could be taxed on a realisation basis, in the same way as other New Zealand assets
   - they could be taxed under the FIF rules like other foreign shares (with the main method of taxation being the FDR method – discussed further in Chapter 8)
   - taxpayers could make a one-off election to tax these interests either on a realisation basis or under the FIF rules, i.e. the FDR method.
2. The Group's preferred view is that interests of less than 10% in listed New Zealand companies should be taxed on realisation, like most other included assets.
3. All other interests in New Zealand shares should also be taxed on a realisation basis.
4. However, taxing capital gains from the sale of New Zealand shares raises particular issues that need to be addressed. This Chapter deals with the relationship between the company and its shareholders, where the shareholder is not also a company. Corporate groups are discussed in Chapter 10.

Double taxation/deduction issues

5. Under current law, a company and its shareholders are effectively only taxed once on the income earned by the company. The company derives income in its own capacity and pays tax on that income. The company then distributes that income to the shareholders, who are also taxed on the income. The company also distributes imputation credits, representing the tax already paid by the company on the income, which the shareholders can use to satisfy their tax liability.

Example 61: General imputation

Hello Issacs Limited earns net income of $100. It pays $28 of tax on that income ($100 x 28%).

Hello Issacs Limited then distributes the income to its shareholder, Jason. Jason receives a $100 dividend comprising $72 cash and $28 of imputation credits.

Jason has a 33% marginal tax rate. Jason details the $100 gross distribution in his tax return and is required to pay $33 of tax. Jason uses the $28 of imputation credits to satisfy most of the tax leaving a liability of $5.[13]

In total, between Hello Issacs Limited and Jason, $33 of tax is paid, i.e. 33% of $100.

13 For simplicity the application of resident withholding tax is ignored in these examples.

6. An extension of the taxation of capital gains gives rise to scenarios where, instead of the company and shareholder effectively being taxed once, or having one deduction for a loss, they could be taxed twice or get two deductions. This is because income or loss in the company will also increase or decrease the value of the shares in the company. Because the disposal of shares will be taxed under an extension of the taxation of capital gains, this could lead to income being taxed, or losses being deducted, at both the company level, when the company sells the asset and the shareholder level, when the shareholder sells the shares.

7. This Chapter discusses these issues outside of corporate groups.

Realised gains – Double taxation

8. The first scenario is where a company has realised gains or other income (i.e. a gain from disposing of an included asset that has increased in value or trading profits). As a result of the realised gains, it is expected that the shares will increase in value. If the shares are sold before the gains are distributed to shareholders, then the gains will be taxed twice. The company will be taxed on the realised gains and the shareholders will be taxed again on the increase in the value of their shares.

Example 62: Double taxation of realised gains

Topp Beer Limited has an included asset that it sells for a capital gain of $100. Topp Beer Limited pays tax of $28 on the $100 capital gain.

Before Topp Beer Limited distributes the gain, its sole shareholder, Colin sells his shares in Topp Beer Limited. The undistributed realised capital gain has increased the value of Topp Beer Limited's shares by $72. Colin is on a marginal tax rate of 33% and has a tax liability of $24 owing to the increase in value of the shares.

In this scenario, total tax paid on the $100 realised capital gain is $52 ($28 by Topp Beer Limited and $24 by Colin).

9. The scope of this problem is likely limited. Data shows that public companies do not tend to accumulate imputation credits. Instead, public companies make regular fully imputed distributions (EY, 2015). If a shareholder sells shares while the company has undistributed imputation credits, the shareholder will not suffer double tax if the market appropriately values the imputation credits in the price of the shares. While the market is unlikely to fully value the imputation credits in the price of the shares, the benefit of the imputation credits will still be shared between the buyer and the seller because the buyer will obtain the benefit of the imputation credits for less than they are worth and the double tax will at least be reduced for the seller.

10. In the case of closely held companies, the shareholders should be able to manage the company to avoid double tax. Double tax should be eliminated for realised gains if the company distributes those as a fully imputed dividend before the shareholder sells its shares. If the company does not have sufficient cash to make a distribution, it could declare a taxable bonus issue of shares, with imputation credits attached.

Example 63: Option A – Imputed dividend

As above, Topp Beer Limited has an included asset that it sells for a capital gain of $100. Topp Beer Limited pays tax of $28 on the $100 capital gain.

Topp Beer Limited pays a fully imputed dividend to Colin of $100, comprising $72 cash and $28 imputation credits. Colin pays tax on the distribution he has received of $33, which is satisfied by $28 of imputation credits and $5 of cash.

Colin then sells his shares in Topp Beer Limited. Because the realised gain has been distributed it will not increase the value of the shares and Colin will not have a capital gain from selling his shares as a result. Therefore, there will be no further tax payable on the realised gain.

Total tax paid on the $100 realised capital gain is $33.

Example 64: Option B – Taxable bonus issue

As above, Topp Beer Limited has an included asset that it sells for a capital gain of $100. Topp Beer Limited pays tax of $28 on the $100 capital gain.

Topp Beer Limited wishes to retain the cash from the realised capital gain for reinvestment. Instead, Topp Beer Limited declares a fully imputed taxable bonus issue of $100, comprising $72 worth of new shares and $28 of imputation credits. Colin is liable to pay tax on the distribution he has received of $33, which is satisfied by $28 of imputation credits and $5 of cash.

Colin then sells his shares in Topp Beer Limited. While the value of the company has been increased by the amount of the capital gain, which has not been distributed, the cost base of Topp Beer Limited's shares has also been increased by $72. Therefore, Colin will not have a capital gain from selling his shares and no further tax will be payable on the realised gain.

Total tax paid on the $100 realised capital gain is $33.

Imputation credit continuity

11. Minimising the risk of double taxation requires maintenance of imputation credits through a change of ownership. However, the current rules around imputation credit continuity will prevent this option from working where there is a change in the ownership of the company of greater than 34%. This is because, under the current rules, imputation credits are lost where the company does not maintain 66% shareholder continuity.

12. The purpose of the imputation credit continuity rule was to prevent inappropriate transfers of tax benefits to shareholders on lower marginal tax rates. However, if all share gains become taxable, this rationale largely disappears. A shareholder cannot escape tax at its marginal rate on the company's retained earnings by selling their shares.

13. Therefore, if the taxation of capital gains is extended, the current imputation credit continuity rules should be removed. However, imputation credits should be quarantined, i.e. the credits can only be used by the current shareholders, if the current shareholders will not be taxed on the sale of the shares because they are tax exempt, e.g. a charity or non-resident. Rules similar to the current Australian rules should be considered. Some targeted anti-avoidance rules may also be required to prevent imputation credit shopping arrangements.

Realised losses – Double deduction

14. The second scenario is where a company has a net loss for the year, i.e. as a result of a loss from disposing of an included asset that has decreased in value or a revenue loss from trading. As a result of the realised loss, it is expected that the shares will decrease in value. If the shares are then sold, the loss could potentially be deducted twice. Both the company and the shareholders will separately get the benefit of the loss that can be offset against other taxable income.

Example 65: Double deduction of realised losses

Newman Cricket Coaching Limited has an included asset that it sells for a capital loss of $100. Assume it has no other losses or gains.

Jenny, the sole shareholder sells her shares in Newman Cricket Coaching Limited. The realised capital loss has decreased the value of Newman Cricket Coaching Limited's shares by $72 ($100 net of tax). Therefore, Jenny also has a capital loss of $72, which she offsets against $72 of other income. Jenny is on a marginal tax rate of 33%. Therefore, this gives rise to a tax saving of $24.

If Newman Cricket Coaching Limited could still use that loss after the sale to shelter a further $100 of income for the new owners there would be a further deduction for those owners.

In this scenario, the total tax saved from the $100 realised capital loss is $52 ($28 for Newman Cricket Coaching Limited and $24 for Jenny).

15. In the case of a sale of a controlling interest in a company, the possibility of a double deduction for realised losses should be limited owing to the loss-continuity rules. The loss-continuity rules require 49% shareholder continuity for losses to be carried forward and used. Therefore, if a major shareholder sells their shares before the losses are used by the company, the losses will be cancelled and the only deduction will be the capital loss on the sale of the shares (although the selling shareholder would have a larger economic loss as a result of selling shares in a way that triggers a breach of continuity).

Example 66: Application of the loss-continuity rules

Patel Contracting Limited has an included asset that it sells for a capital loss of $100.

Patel Contracting Limited has no other income so the loss results in a loss carry forward of $100.

The realised capital loss has decreased the value of Patel Contracting Limited's shares by $100. Hiran, the sole shareholder, sells his shares in Patel Contracting Limited, which generates a capital loss of $100. He offsets the loss against $100 of other income. Hiran is on a marginal tax rate of 33%. Therefore, this gives rise to a tax saving of $33.

The loss to carry forward in Patel Contracting Limited is forfeited when Hiran sells his shares to a new owner, owing to the current continuity rules that require a 49% continuity of shareholding to carry forward a loss.

In this scenario, total tax saved from the $100 realised capital loss is $33.

16. Where the loss in the company survives a share sale because it does not trigger a 49% change in the continuity of ownership, or if the loss-continuity rules are repealed or loosened, then a double deduction may arise. However, this double deduction will reverse once the loss is used and the purchasing shareholder sells their shares or the company is liquidated. The issue seems small enough that it does not need to be addressed.

17. While this solution works for individual companies, where a company is part of the same corporate group, i.e. a group of two or more companies with 66% common ownership, the loss could be transferred to another group company and used before a majority shareholder sells their shares. This will result in a double deduction for the loss. This situation can be resolved by adjusting the cost base of the shares. This is discussed in detail in Chapter 10.

Unrealised capital gains – Double taxation

18. The third scenario is where a company has an unrealised capital gain, i.e. an included asset has increased in value but has not yet been sold. As a result of the unrealised capital gain, it is expected that the shares will increase in value. If the shares are sold before the capital gain is realised and distributed to shareholders, then the gain will be taxed twice. First the shareholder will be taxed on the sale of the shares, then the company will be taxed on the realised capital gain.

Example 67: Double taxation of unrealised gains

Faynie Limited has an included asset that has increased in value by $100.

The sole shareholder, Fay, sells her shares in Faynie Limited. The unrealised capital gain has increased the value of Faynie Limited's shares by $72 (the gain less the company tax that will arise on the gain).[14] Fay is on a marginal tax rate of 33% and has a tax liability of $24 owing to the increase in value of the shares.

Faynie Limited later sells the included asset and realises the $100 capital gain paying tax on the realised capital gain of $28.

In this scenario, total tax paid on the $100 capital gain is $52 ($24 by Fay and $28 by Faynie Limited).

19. This issue should be considered further through the generic tax policy process. One possible outcome is to do nothing. In general, when a person purchases a company with assets that are increasing in value, they will want to hold those assets for a period, rather than immediately disposing of them, especially assets that are essential to the business. In this case the market might value the shares without taking into account any potential company tax on the sale of those assets. The parties can also choose to sell the assets rather than the shares, which eliminates this issue altogether.

Unrealised capital loss – Double deduction

20. The final scenario is where a company has an unrealised capital loss, i.e. an included asset that has decreased in value but has not yet been sold. As a result of the unrealised capital loss, it is expected that the shares will decrease in value. If the shares are sold before the capital loss is realised, then both the shareholder and the company will be able to benefit separately from the loss. The shareholder will benefit when they sell their shares and the company will benefit when it eventually sells the included asset.

Example 68: Deduction of unrealised losses

Derek Menswear Limited has an included asset which has decreased in value by $100.

Ian, the sole shareholder, sells his shares in Derek Menswear Limited. The unrealised capital loss has decreased the value of Derek Menswear Limited's shares by $72. Therefore, Ian has a capital loss of $72, which he offsets against $72 of other income. Ian is on a marginal tax rate of 33%. Therefore, this gives rise to a tax saving of $24.

Derek Menswear Limited then sells the included asset and realises the $100 loss. Derek Menswear Limited offsets this loss against $100 of other income, giving rise to a $28 tax saving.

In this scenario, the total tax saved from the $100 unrealised capital loss is $52 ($28 for Derek Menswear Limited and $24 for Ian).

14 It is possible that the purchaser would pay up to $100 for this unrealised gain, depending on the facts. This does not affect the principle of the example.

21. In most cases, when small amounts of shares are traded, this scenario will only result in minor issues that can be ignored. However, the Group is concerned about the result when a large proportion of the shares are disposed of. This could result in avoidance opportunities, which is undesirable.

22. The Group considers that it is desirable to address this issue if practical. This issue should be considered further through the generic tax policy process. An approach could be treating the sale of the shares as a sale of the underlying assets of the company, as discussed above for unrealised capital gains (paragraph 19). This deemed sale could be compulsory where the:

- majority of shares in a company are sold
- value is less than a certain percentage of the net tax value of the business.

23. Further analysis is needed to ensure it works appropriately in all cases.

Liquidation

24. Under current law, amounts distributed on the winding up of a company are treated:

- first, as a return of available subscribed capital (ASC) i.e. the capital that shareholders have contributed to the company on a pooled basis
- second, as a distribution of net capital gains that have arisen over the life of the company, and
- lastly, as a dividend.

25. ASC and net capital gains can be distributed tax free on liquidation of a company. Where shares are held on revenue account, so that any gain on sale is taxable, an amount that is taxable as a dividend cannot also be taxable as sale proceeds.

Example 69: Current rules for liquidation

Rajesh owns shares in Lines Limes Limited, which he purchased for $100. He holds the shares on revenue account.

Lines Limes Limited goes into liquidation. It makes a distribution to Rajesh of $200 comprised of:

- $50 ASC
- $100 net capital gains
- $50 dividend income.

Rajesh is required to pay tax on the $50 dividend. In addition, because he held the shares on revenue account, he will be required to pay tax on the gain he has made on the shares. The $50 dividend cannot also be taxable as sale proceeds. Therefore, Rajesh's gain is $50 (i.e. $150 – $100).

26. This ordering rule for distributions made on liquidation would not be affected by an extension of the taxation of capital gains. However, the rules will need to be modified to ensure:

- only capital gains made prior to the extension of tax on capital gains are passed to shareholders tax free on a liquidation, and
- any funds or assets received by shareholders on liquidation are consideration for the disposal of those shares, to the extent that they are not dividends.

Example 70: Solvent liquidation

Kelly owns shares in Flags 'R Us Limited, which she purchased for $50. The value of her shares on Valuation Day is $150.

Flags 'R Us Limited goes into liquidation. It makes a distribution to Kelly of $400 comprised of:

- $50 ASC
- $100 net capital gains that arose prior to the introduction of the new rules
- $250 dividend income (which includes $100 of net capital gains that arose post the introduction of the new rules).

Kelly is required to pay tax on the $250 dividend income which includes $100 net capital gains that arose post the introduction of the new rules. In addition, under the new rules, she will be required to pay tax on her capital gain. Kelly's total capital gain is nil (i.e. the total capital portion of the distribution ($150) less her Valuation Day value ($150).

Example 71: Insolvent liquidation

Knight Counselling Limited was set up by the sole shareholder Mitch in 2019 to provide career advice to tax policy analysts looking to move out of tax. Mitch set up the company with $10,000 of his own funds and borrowed $2,500 from a bank to supplement his own funds.

Unfortunately, the demand for tax policy analysts in non-tax areas was low and Mitch's company failed to perform as expected and this resulted in heavy losses. On Valuation Day the market value of Mitch's investment was $8,000, reflecting the losses made to that date. In 2022 the bank puts the company into liquidation, at a time when it has retained losses of $12,500. The company has the following balance sheet at the liquidation:

- Cash $0
- Capital $10,000
- Retained Earnings ($12,500)
- Loan from Bank $2,500.

The liquidation is a realisation of Mitch's investment in the company and therefore he needs to calculate a gain or loss on disposal for tax purposes.

Mitch calculates his loss on disposal as $8,000, being the proceeds from sale ($nil) – the median of $8,000 (sale price $0, market value $8,000 and cost price $10,000).[15]

15 This example assumes that Knight Counselling Limited has not offset any of the losses to another group entity.

8

Specific regimes – Taxation of foreign shares

1. This chapter discusses the tax treatment for capital gains arising from investments in foreign shares.

Controlled foreign companies

2. The controlled foreign company (CFC) regime applies to interests of 10% or more in foreign companies that are (generally) 50% or more controlled by five or fewer New Zealand residents.

3. Under the current CFC regime:

   - Where the income derived by the CFC is mostly passive income, e.g. interest or dividend income, the CFC will be an 'attributing CFC' and the shareholders' share of income earned by the foreign company is treated as taxable income of a New Zealand resident shareholder, with a credit for foreign tax paid.

   - Where the income derived by the CFC is mostly derived from an active business or the CFC is resident in Australia, the CFC will be a non-attributing CFC and the income will not be attributed to a New Zealand resident shareholder.

4. The same rules should apply to determine whether capital gains or losses from the sale of included assets by a CFC should be subject to tax for a New Zealand resident shareholder. This means that if the CFC is non-attributing, capital gains of the CFC will not be taxable income for a New Zealand resident shareholder.

Example 72: Attributing vs non-attributing

New Zealand Co, a New Zealand resident company, owns Machines Co, which is a company resident in Italy that produces washing machines. Machines Co carries on an active business and pays tax on its income in Italy. Machine Co sells some intellectual property relating to the design of one of its machines, for a profit. Because Machines Co is an active business the capital gain will not be attributed to New Zealand Co, but note that the capital gain could be taxed in Italy.

New Zealand Co also owns Investor Co, which is a company resident in Germany that invests in shares. Investor Co carries on a passive business. Investor Co sells some of its share portfolio for a profit. Because Investor Co is a passive business, the capital gain will be attributed to New Zealand Co and will form part of its taxable income.

5. Where a New Zealand resident shareholder sells an interest in a CFC, there should be different treatments for New Zealand resident shareholders that are companies, compared with other shareholders. This ensures that New Zealand companies investing in foreign businesses are not taxed more heavily than residents of the CFC's jurisdiction or other foreigners making the same investment. The gain will instead be taxed when the shareholders of the New Zealand resident company sell their shares or when the New Zealand resident company distributes the proceeds to its shareholders.

6. In line with the current rules discussed above, company shareholders should not be taxed on gains from sales of interests in non-attributing CFCs. However, company shareholders should be taxed on gains from sales of interests in attributing CFCs. All other shareholders should be taxed on gains from sales of interests in both non-attributing and attributing CFCs.

Example 73: Companies vs individuals

New Zealand Co owns 50% of Shoes Co, a shoe manufacturer in China. New Zealand Co is 100% owned by Tim. The other 50% is owned by Pam, who is a New Zealand resident. Both New Zealand Co and Pam decide to sell their shares in Shoes Co to an independent third party. They both make a profit on the sale.

Shoes Co is an active business. Therefore, the capital gain from the sale of the shares in Shoe Co will not be taxable income of New Zealand Co. However, Tim will be taxed on the capital gain, either when the proceeds from the sale of the shares of Shoe Co are distributed by New Zealand Co or when Tim sells his shares in New Zealand Co. The capital gain will be taxable income for Pam.

7. Where a CFC derives both active and passive income and the passive income is more than 5% of the CFC's total income, any gain from a sale of an interest in the CFC by a New Zealand company shareholder should be apportioned based on the value of the assets used to derive the two types of income. The gain or loss relating to the active assets should not be taxable for New Zealand company shareholders. Consideration needs to be given to whether the current definitions of active assets will need to be amended as part of the generic tax policy process.

Foreign investment funds

8. The foreign investment fund (FIF) regime applies to most other interests in foreign companies. However, currently it does not apply to:
   - interests of more than 10% in Australian resident companies
   - interests of less than 10% in Australian resident listed companies, or
   - interests held by a person whose total foreign share portfolio cost less than $50,000 to acquire, if the person elects not to return FIF income.

9. Under the FIF regime, income from FIF interests is calculated under one of a range of methods. Individuals and family trusts with less than 10% holdings must use one of the following:
   - **fair dividend rate (FDR) method** – tax is calculated based on 5% of the annual opening value of the foreign share portfolio, with no tax on actual dividends and accrued gains or losses received during the year
   - **comparative value (CV) method** – tax is calculated based on dividends received and accrued gains and losses during the year.

10. In most other cases, taxpayers with less than 10% holdings must use the FDR method.

11. The FDR method should be retained as the main method for taxing income from FIF interests of less than 10%. In the *Interim Report*, the Group noted that the fall in risk-free rates of return since 2007 could indicate that a 5% FDR rate may now be too high. However, lowering the FDR rate at the same time as increasing tax on New Zealand shares, by taxing capital gains more comprehensively, could cause an investment bias away from New Zealand shares and into foreign shares. To meet changing economic conditions, the FDR rate should be able to be adjusted more regularly. The FDR rate should be set by regulation, with a specified formula contained in the empowering legislation. However, the formula should have regard to a principle that foreign shares should not be taxed more favourably than domestic shares.

12. Under an extension of the taxation of capital gains, there are three options for taxing interests of less than 10% in foreign companies that are currently excluded from the FIF regime, i.e. interests in Australian resident listed companies and for portfolios costing less than $50,000:[16]

    - they could be taxed on a realisation basis, in the same way as other New Zealand assets
    - they could be taxed under the FIF rules like other foreign shares (with the main method of taxation being the FDR method)
    - taxpayers could make one-off elections to tax these interests either on a realisation basis or under the FIF rules, i.e. the FDR method.

13. The Group's preferred view is that holdings of less than 10% in foreign companies currently excluded from the FIF regime should be taxed on a realisation basis.

Example 74: Australian listed shares

Tia owns a small interest (less than 10%) in an Australian listed company. Tia holds her shares as a long-term investment.

Prior to the introduction of an extension of the taxation of capital gains, Tia would not have been required to pay tax on the sale of her Australian shares. She would only be taxed on the dividend income she received. After the introduction of an extension of the taxation of capital gains, Tia will be required to pay tax on any capital gain she receives when she sells her Australian shares.

14. Interests of greater than 10% in FIFs that are Australian resident companies, and currently excluded from the FIF regime, should be subject to the treatment proposed for non-attributing CFCs, discussed above.

15. Finally, under current law, individuals and family trusts have an option to alternate between applying the FDR method and the CV method where the annual actual return is less than the 5% deemed return under the FDR method (with a floor of $0). In the Group's view, this concession is anomalous and inconsistent with the idea behind taxing a risk-free return. It also potentially creates a bias in favour of non-Australasian shares because taxpayers are subject to a maximum 5% rate of return but can elect the actual rate of return if it is lower. Comparatively, there is no maximum rate of return for Australasian shares under a realisation basis of taxing capital gains but capital losses would be available on a ring-fenced basis. If the FDR rate is ultimately lowered from 5%, the Group recommends removing the ability to choose to apply the CV option only in years where shares have returned less than 5%. Alternatively, taxpayers who currently have this option could be given a one-off chance at the time the option to alternate is removed, to elect to apply either the FDR or the CV method to their whole portfolio going forward.

16 The interaction between this proposal and the current foreign superannuation fund rules will need to be considered.

9

Specific regimes – Taxation of KiwiSaver and other managed funds

Introduction

1. Managed funds, including those created for retirement savings, such as KiwiSaver funds, make investments on behalf of a pool of investors. The Group believes it is important to separately consider these entities because they have an important role in investing New Zealand's capital.

2. Managed funds hold investments in financial instruments, e.g. bonds, Government stock etc, New Zealand shares, including listed shares and a very small holding of unlisted shares, Australian shares, other foreign shares and real property (i.e. land). The main issue with extending the taxation of capital gains to managed funds is how to tax New Zealand shares and Australian listed shares ('Australasian shares') and real property. This is because managed funds currently do not pay tax on any gains from selling these assets.

3. Under an extension of the taxation of capital gains, other kinds of assets held by managed funds should continue to be taxed as they are currently. A fund's financial instruments should continue to be taxed on a full accrual basis under the financial arrangement rules and non-Australasian shares should continue to be taxed under the current FDR method.

Types of managed funds

4. There are several different types of managed funds, with different tax treatments. These are:

   - portfolio investment entities (PIEs) that include:
     - multi-rate PIEs (MRPIEs), including KiwiSaver funds, that own shares and financial instruments
     - Listed PIEs that own shares and financial instruments
     - property-owning PIEs (either Listed PIEs or MRPIEs that hold real property, and involve different considerations)
   - superannuation funds, and
   - life insurance funds.

5. This chapter discusses the recommended rules for each of these fund types.

MRPIEs that own shares and financial instruments, including KiwiSaver funds

6. MRPIEs are a special type of managed fund where income is regularly attributed to investors, based on their interest in the PIE, and tax is paid by the PIE on the investors' behalf at the investors' PIE tax rates.

7. This section focuses on MRPIEs that invest in shares and financial instruments. As noted above, financial instruments and most foreign shares will continue to be taxed as they are currently. Therefore, the following section focuses on how investments by MRPIEs in Australasian shares will be taxed.

8. MRPIEs, including KiwiSaver funds, should be taxed on their Australasian shares on an accrual basis. This is different from the treatment proposed for directly held Australasian shares but fits better with the systems required to comply with the existing PIE tax rules. The accrual method is the same as the current CV method under the FIF regime. It taxes an investor on their total accrued economic gain in respect of the shares each year, being:
    - the increase or decrease in the value of the portfolio during the year (the closing value of the portfolio less the opening value) plus
    - gains (i.e. distributions and sale proceeds received) less
    - costs, including the cost of acquiring shares during the year.

Example 75: Australasian shares in MRPIEs

Fund X is an MRPIE. It invests in Australasian shares. The opening value of its Australasian share portfolio for the 2025 income year is $1 million. At the end of the 2025 income year, the value of the Australasian share portfolio is $1.25 million. During the year, the fund derives $500,000 from selling shares and incurs costs of $400,000 in purchasing new shares. Fund X also receives $200,000 of dividend income during the year.

Fund X's taxable income from its Australasian shares will be calculated as follows:

Income = (closing value + gains) – (opening value + costs)

= ($1.25 million + $200,000 + $500,000) – ($1 million + $400,000)

= $550,000

9. Each investor should continue to be attributed their share of the income of the MRPIE, which is taxed at the investors' PIE tax rates. Investors in MRPIEs should continue to receive tax-free distributions from MRPIEs. Investors should not be taxed on any gains from selling or redeeming their interests in an MRPIE.

10. Currently, MRPIEs cash out losses attributable to natural person or certain family trust investors, i.e. Inland Revenue refunds the tax effect of the loss to the MRPIE and investors are issued new units in the MRPIE equal to the amount of the refund. If Australasian shares are taxed on an accrual basis, those losses that can be cashed out should include accrued unrealised capital losses from Australasian shares. Those losses should not be ring-fenced.

11. While taxing on an accrual basis is the best option for MRPIEs, it will cause perceived timing disadvantages compared to taxing on a realisation basis, where tax is deferred until disposal. Measures should be considered to ameliorate this timing disadvantage. Options could include discounting the amount of gain or loss attributed from Australasian shares or reducing the PIE tax rates for KiwiSaver funds. However, the lower rate, and the fact that losses can be cashed out, may already adequately compensate for this.

Listed PIEs that own shares and financial instruments

12. Listed PIEs are generally taxed like companies. However, investors are not taxed on unimputed distributions and they can elect whether to be taxed on imputed distributions. This section focuses on listed PIEs that invest in shares and financial instruments.

13. Australasian shares held by Listed PIEs should be taxed on an accrual basis, with a possible discount, in the same way as for MRPIEs.

14. Investors in Listed PIEs would continue to receive unimputed distributions tax free and to have the option of returning imputed distributions. All sales of interests in Listed PIEs should also be tax free. This reflects the fact that the income is taxed on accrual within the Listed PIE.

Property PIEs

15. PIEs that hold real property (i.e. land) will need to become a separate subclass of PIE (a 'Property PIE'). A Property PIE would not be allowed to invest in other types of assets (although they could operate bank accounts etc). Property PIEs could continue to be either MRPIEs or Listed PIEs but their tax treatment would be modified as discussed below.

16. Where investors invest directly, i.e. not though another managed fund, in a Property PIE that is an MRPIE, the Group recommends two options:

    - Under the first option, the investors would be treated as if they own the underlying property directly (similar to a partnership). Tax would then be payable on a realisation basis, both when the MRPIE disposes of the property and when an investor exits the MRPIE, either as a sale or redemption, which would be treated as a partial sale of the investor's share of the underlying property. Tax on the sale of the property would be paid by the PIE, while tax on the sale of an investor's units would be reported by the PIE but paid by the investor. Distributions from the PIE would not be taxed.

Example 76: Direct investment into a Property PIE that is an MRPIE – Option A

Fund Y is a Property PIE that is an MRPIE. It owns a commercial building that was originally purchased for $4 million. Person A is a direct investor who holds a 5% interest in Fund Y. Person A invested on day 1 of Fund Y's existence, so their cost base is 5% of the $4 million, being $200,000.

After five years, the commercial building has increased in value to $5 million. At this point Person A decides to sell their interest in Fund Y. Person A will be treated as selling their 5% of the commercial building for $250,000. This will give rise to a capital gain for Person A of $50,000 ($250,000 – $200,000).

Fund A will report this tax on behalf of Person A but person A will pay the tax.

- Under the second option, the MRPIE would be taxed more like an ordinary company. The MRPIE would continue to attribute its income to its investors, including any income from selling the property. Investors would not be taxed on any distributions but they would be taxed on any gain from selling or redeeming their interests in the MRPIE (treated like a share sale). To prevent permanent double taxation/deductions issues, the cost base of an investor's interest in the MRPIE would:
  - increased by the amount of income attributed to the investor under the MRPIE rules each year, and
  - reduced by the amount distributed to them by the MRPIE each year.

Example 77: Direct investment into a Property PIE that is an MRPIE – Option B

Fund Z is a Property PIE that is an MRPIE. It owns a commercial building that was originally purchased for $2 million. Person B is a direct investor who holds a 5% interest in Fund Z. Person B invested on day one of Fund Z's existence, so their cost base is 5% of the $2 million, being $100,000.

In year two, Fund Z derives a small amount of rental income attributed to the investors. $100 is attributed to Person B and Fund Z pays tax on the $100 at Person B's PIE tax rate. This increases Person B's cost base by $100 to $100,100.

In year three, Fund Z distributes $200 to Person B, on which Person B is not taxed. This decreases Person B's cost base by $200 to $99,900.

After five years, the commercial building has increased in value to $4 million. At this point Person B decides to sell their interest in Fund Y. At this point his interest has increased in value to $200,000. Person B will be required to pay tax on the increase in value of their interest, taking into account the increases and decreases to the cost base. This will give rise to a capital gain of $100,100 ($200,000 – ($100,000 + $100 - $200)).

17. Where investors invest directly into Property PIEs that are Listed PIEs, the Listed PIE would continue to be treated like ordinary companies and taxed on any gain from selling the property. However, investors would also be taxed on any imputed dividends and on any gain from selling their shares in the Listed PIE. Unimputed dividends would generally be taxable. However, the investor would have the option to treat the unimputed dividends as non-taxable and instead reduce the cost base of their shares in the Listed PIE (effectively ensuring that unimputed distributions are taken into account when the investor sells their shares).

Example 78: Direct investment into a Property PIE that is a Listed PIE

In year one, Person C purchases shares in Fund W, which is a Property PIE that is a Listed PIE, for $1,000.

In year two, Person C receives an unimputed distribution of $100. Person C chooses to adjust their cost base rather than paying tax on the distribution. As a result, the cost base of Person C's shares is reduced to $900.

In year three, Person C sells their shares in Fund W for $1,500. They will be subject to tax on the capital gain on the sale of their shares of $600 (being $1,500 – $900).

18. Property PIEs would be required to assist their direct investors in calculating their cost base adjustments (where applicable) by, for example, providing annual statements and/or an online calculator.

19. Where a Property PIE (either MRPIE or Listed PIE) has managed fund investors, those managed fund investors would not make any adjustments to the cost base of their interests in the Property PIE and would not be taxed on any attributed income. Instead, they would calculate their income from the Property PIE on an accrual basis, the same way as for their investments in Australasian shares.

Example 79: Managed fund investment into a Property PIE

Fund F holds 20% of Fund G. Fund G is a Property PIE that owns a commercial property.

At the beginning of year one, Fund F's interest in Fund G was valued at $1 million. At the end of year one, Fund F's interest in Fund G is valued at $1.2 million. Fund G also pays a $100,000 unimputed distribution to Fund F during the year. Fund F calculates its income in respect of its interest in Fund G under the accrual method:

Fund F's income = (closing value + gains) – (opening value + costs)

= ($1.2 million + $100,000) – ($1 million)

= $300,000

Fund F does not make any cost basis adjustment to its interests in Fund G.

Superannuation funds

20. Superannuation funds are currently taxed like trusts. All income is taxed as trustee income, usually at 28% and is distributed to the beneficiaries tax free.

21. Australasian shares held by superannuation funds should be taxed in the same way as MRPIEs, i.e. on an accrual basis, possibly with a discount. Any real property owned by a superannuation fund should also be taxed on an accrual basis (although superannuation funds do not have significant direct investments in land).

22. However, small superannuation funds, e.g. with less than $5 million in assets, should be able to account for gains on their Australasian shares and land on a realisation basis.

Life insurance funds

23. Life insurers with a policyholder base calculate their annual income and deductions and apportion them between the shareholder base and the policyholder base. However, many life insurers no longer have a policyholder base, as they only issue term life insurance and not life insurance policies with a savings component.

24. Australasian shares held by life insurers with a policyholder base should also be taxed in the same way as MRPIEs, i.e. on an accrual basis, possibly with a discount. Any real property owned by a life insurer with a policyholder base should also be taxed on an accrual basis, although life insurers do not have significant direct investments in land.

25. Life insurers with no policyholder base are currently taxed the same way as other companies. Accordingly, they should be taxed on their Australasian shares and land in the same way as an ordinary company (i.e. on a realisation basis).

Investment restrictions

26. The managed fund sector, including KiwiSaver, does not typically invest in certain kinds of investments that would provide benefits to New Zealanders. This includes investments like venture capital, infrastructure, social housing and sustainable investment. This is because these types of investment typically are not liquid or easily valued. The Government should consider if there is a way to help managed funds, particularly KiwiSaver, make these kinds of investments.

10

Specific regimes – Taxation of corporate groups

Introduction

1. Corporate groups, for tax purposes, are groups of two or more companies that have 66% or more common ownership.

2. Chapter 7 discussed the double taxation and double deduction issues that could arise from the introduction of a capital gains tax for individual New Zealand companies and their shareholders. The same issues arise in a corporate group context. However, these issues can be compounded because the double taxation or deduction can be repeated through a chain of companies and because dividends between members of a wholly-owned group are tax exempt.

Example 80: Double deductions in a corporate group

Company A incurs a loss of $100. Company A transfers the loss to Company B, which is part of the same corporate group. Company B offsets the $100 loss against its taxable income.

As a result of incurring the loss, Company A's shares fall in value. If Company A is then sold, without Company B, the shareholders will realise a capital loss, which would be deductible if there is an extension of the taxation of capital gains. This would effectively allow the same economic loss to be deducted twice within the group.

3. This chapter discusses the proposed solutions to some of these double deduction issues in a corporate group context.

4. The Government should also consider whether the introduction of compulsory consolidation rules similar to those in Australia is appropriate. While Australia's consolidation regime is more complex than the rules discussed here, it may be a more comprehensive and effective solution to the issues raised by the extension of taxation of capital gains in a corporate group context. In particular, it may ensure there is no revenue leakage from multiple deductions within corporate groups.

5. The proposals below were included in the *Interim Report*. The Group has received limited comment on these proposals but recognises that these rules will be complex and incur high compliance costs. Consequently, these measures need to be considered further as part of the generic tax policy process.

Loss transfers within corporate groups

6. Companies within a corporate group can transfer tax losses between them, i.e. a company that has incurred a loss can transfer that loss to another company that has taxable income to offset any tax payable. The Income Tax Act provides two options for transferring losses:

   - **a loss offset** – where a loss is simply transferred to another group company, and

- **a subvention payment** – where a profit company effectively buys the loss from a loss company (the profit company makes a payment to the loss company equal to the loss, giving rise to a deduction for the profit company and assessable income that offsets the loss for the loss company).

7. To the extent that a loss is transferred as a subvention payment, the double deduction issue does not arise. This is because the payment received by the loss company offsets the loss, meaning the shares will not fall in value.

8. Similarly, it is common for group companies to make a payment for the tax effect of a loss offset to ensure the tax liabilities are accurate in each group entity. This will result in a partial offset of the effect of the loss on the value of the company.

9. However, as illustrated in Example 80 above, transferring losses as a loss offset can cause multiple deductions for the same loss. This issue should be addressed by adjusting the cost base of a company's shares to the extent there is no payment for the loss.

10. The cost base of a company's shares is determined based on:

    - the acquisition cost of the shares – being either their purchase price or the amount the shareholder contributed to the company in exchange for the issue of shares, and

    - any further capital contributed to the company by the shareholder (where no further shares have been issued).

Reduction in cost base

11. Where a loss is transferred within a corporate group to the extent consideration is not received for that loss:

    - the cost base of the loss company's shares, i.e. the company transferring the loss, should be reduced by the amount of the loss transferred, and

    - the cost base of the profit company's shares, i.e. the company receiving the loss, should be increased by the amount of the loss transferred.

12. The adjustment to the loss company's shares will eliminate the double deduction that would otherwise arise on the sale of the shares, because the cost base will reflect the decrease in value of the shares. The adjustment to the profit company's shares reflects the fact that the profit company has received the benefit of having the loss to offset its taxable income, increasing its value. These equal and opposite adjustments will also ensure that the total cost base of the group's shares will not change. This reflects the fact that the total amount the shareholders paid for the shares in the group (collectively) has not changed.

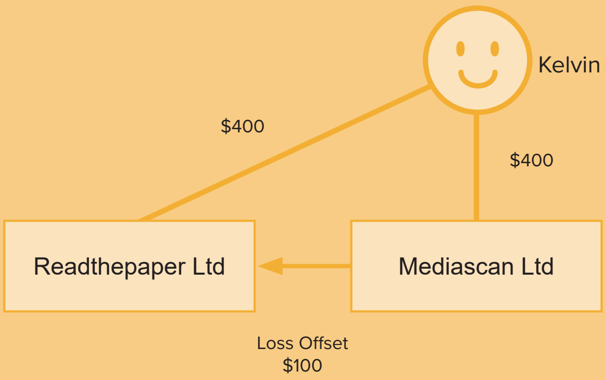
Example 81: Adjusting the cost base

Kelvin owns all the shares in Mediascan Limited that were purchased for $500. Mediascan Limited incurs a loss of $100. Mediascan Limited transfers the $100 loss to Readthepaper Limited, a sister company, for no consideration. The cost base of Readthepaper Limited's shares is $300.

Under the proposed rules, Mediascan Limited will be required to reduce the cost base of its shares by the amount of the loss transferred (i.e. to $400), to reflect the reduction in the value of the shares. If Kelvin sells the shares in Mediascan Limited at this point there will be no loss and, therefore, no double deduction.

The cost base of Readthepaper Limited's shares will also need to be adjusted to $400 to reflect the benefit of receiving the loss.

Overall, the total cost base of the group remains at $800.



Example 82: Chain of companies

Loss Co is wholly owned by Loss Parent 1. Loss Parent 1 is wholly owned by Loss Parent 2, Loss Parent 2 is wholly owned by Top Co. The total cost base for the group is $1,000.

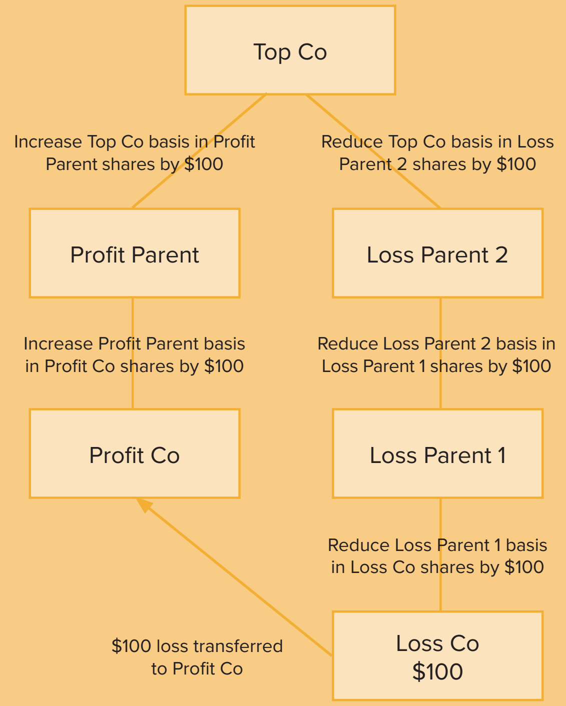
Loss Co transfers a $100 loss to Profit Co, a company in the same wholly-owned group. This will require the following adjustments:

- Loss Parent 1 will be required to reduce its cost base in Loss Co by $100.
- Profit Parent 1 will be required to increase its cost base in Profit Co by $100.

Because Loss Co and Profit Co are part of a chain of companies, this treatment must be mirrored all the way up to Top Co as follows:

- Loss Parent 2 will be required to decrease its cost base in Loss Parent 1 by $100.
- The shareholders in Top Co will not be required change their cost base as it is the ultimate parent of the group.

This ensures that the cost base of the companies reflect their changes in share value as a result of the loss offset, while ensuring that the total cost base of the group remains at $1,000.



13. The cost base adjustments should occur with effect from the last day of the income year in which the losses are transferred. This reflects the fact that loss transfers are usually made at the end of the year when the tax return is prepared. However, where a loss transfer is made during an income year, and prior to the sale of a company, the cost base adjustments must be made immediately before the sale.

Chain of companies

14. Where a loss is transferred between two companies in a chain of companies, the adjustments should be reflected up the chain to the ultimate parent company.

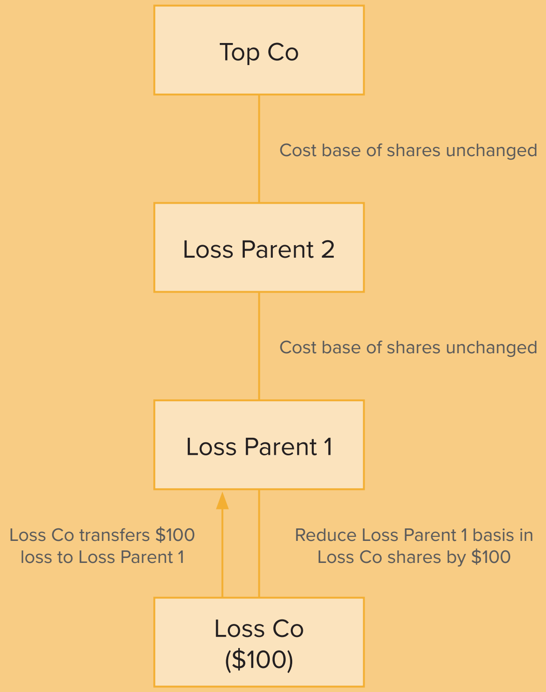
15. Where the loss offset is made to the parent of the loss company, the loss adjustment is only made to the cost basis of the loss company and does not travel up the chain of entities, as there are equal and offsetting adjustments that would be made.

Example 83: Loss offset to parent

Loss Co:

- has a cost base of $600
- incurs a loss of $100, and
- transfers that loss to Loss Parent 1.

Loss Co will be required to reduce its cost base by the amount of the loss. No other adjustments will be required to the cost basis of the group as there will be equal and offsetting adjustments made, increasing and decreasing the cost base for the other parent companies up the chain for the loss offset.



Loss greater than cost base

16. If the value of the loss is greater than the shareholder's cost base of the loss company's shares, the cost base should only be reduced to nil. An equal adjustment should be made to the profit company's shares and mirrored up the chain of companies if applicable.

Example 84: Loss greater than cost base

The shareholder in Company A has a cost base in its Company A shares of $400. Company A incurs a loss of $500. Company A transfers that loss to Company B, which has a cost base of $800.

The shareholder in Company A will be required to reduce its cost base in Company A to nil.

The shareholder in Company B will be required to increase its cost base in its Company B shares by the amount of the loss. However, the increase in Company B's cost base must equal the amount of the reduction in Company A's cost base (being $400). Therefore, Company B's cost base will only increase by $400 (to $1,200) instead of by the full $500 amount of the loss.

Minority shareholders

17. The loss-transfer provisions require at least 66% common ownership. Therefore, it is possible there could be minority shareholders who do not have an equal interest in both the loss and profit companies. As minority shareholders will not benefit from the loss transfer, because they do not own both companies, no adjustment should be made to the cost base of their shares. Instead, 100% of the loss transfer should be reflected in the cost base of the majority shareholders' shares, i.e. the shareholders who have an equal interest in both the loss and profit companies.

Exempt corporate dividends

18. Although a dividend transfers value from the company to the shareholder it will not generally affect the cost base of the shareholder's shares. This is appropriate, because the dividend itself is taxable to the shareholder.

19. This treatment for dividends is appropriate even if the shareholder level tax is reduced by the attachment of an imputation credit. If an imputed dividend is paid, the distribution will consist of tax paid income. If the cost base of the shares was reduced by the amount of the dividend, this would give rise to double taxation of that income. The income would be taxed once in the company and, if there was a reduction in the cost base, again when the shareholder sold their shares.

Example 85: Fully imputed distribution

Keith, on a tax rate of 33%, purchased all the shares in Kilo Limited for $200. Kilo Limited derives $50 of taxable income and pays tax on that income of $14. Kilo Limited distributes the income to Keith as a fully imputed dividend (consisting of $36 cash and $14 of imputation credits). Keith pays $2.50 tax on the dividend. After the distribution, the value of Kilo Limited's shares is still $200.

If Keith's cost base in Kilo Limited was reduced by the amount of the dividend (i.e. to $150), then when Keith sold the shares for their value of $200, they would be deemed to have made a $50 taxable gain (i.e. $200 – $150). This would mean that the $50 would be taxed twice: once in the company and again for the shareholder.

20. Dividends paid within a New Zealand wholly-owned group are exempt income for the recipient company. Where an imputed dividend is paid within a wholly-owned group, from tax paid income, no problem arises because tax has been paid.

21. However, it is possible for a wholly-owned subsidiary to pay an unimputed dividend to a parent, e.g. by borrowing against unrealised capital gains, decreasing the value of the subsidiary but with no tax liability for the parent company. If the parent company then sold the subsidiary, there would be no capital gain. Instead, the parent would have benefited by receiving an exempt dividend.

22. This issue should be addressed by decreasing the cost base of the subsidiary's shares by the amount of the unimputed dividend paid.

Example 86: Exempt dividend

Sub Co is a wholly-owned subsidiary of Parent Co. Parent Co's cost base in the shares of Sub Co is $500.

Sub Co has an unrealised capital gain of $100. This increases the value of Sub Co to $600. Sub Co borrows $100 from the bank and distributes this amount as an unimputed exempt dividend to Parent Co. This reduces the value of Sub Co back to $500.

Parent Co then sells Sub Co to a third party for its value of $500. As Parent Co's cost base is $500, there is no taxable capital gain. If there is no adjustment to the cost base of the Sub Co shares, Parent Co has derived the benefit of the capital gain tax free, by receiving an exempt dividend.

However, if the exempt dividend reduces Parent Co's cost base in Sub Co to $400 (i.e. $500 less the $100 unimputed dividend), then the sale of Sub Co will result in a $100 taxable capital gain for Parent Co, reflecting the actual increase in the value of Sub Co.

23. Where companies in a wholly-owned group are also part of an imputation group, imputation credits generated by the payment of tax by one company can be attached to dividends paid by another. This allows the result described in Example 86 above to be achieved with imputed dividends. Therefore, in principle the cost base of a subsidiary's shares should also be decreased by the cash component of an imputed dividend, where the subsidiary has used imputation group credits to pay the fully imputed dividend but this is something that should be consulted on.

Example 87: Imputation groups

Sub Co and Parent Co are part of the same wholly-owned group. They, along with the other companies in the wholly-owned group, have also formed an imputation group.

Parent Co's cost base in Sub Co is $500. Sub Co has an unrealised gain of $100, increasing its value to $600. Sub Co borrows $100 from the bank. Sub Co uses imputation credits generated by payments of tax by other companies in the imputation group to fully impute a $100 dividend. The dividend is exempt income of Parent Co.

As a result of the dividend, the value of Sub Co is decreased to $500. If Parent Co sold Sub Co for its value, it would not derive any capital gain. However, if Parent Co's cost base in Sub Co was reduced by the cash component of the imputed dividend, i.e. by $100, then Parent Co would derive a $100 capital gain, reflecting the actual gain in the value of Sub Co.

Consolidated groups

24. Where New Zealand resident companies are part of a wholly-owned group, i.e. they have 100% common ownership, they can elect to form a 'consolidated group'. Where companies form a consolidated group they are, essentially, taxed as if they are one entity. However, companies that are members of a consolidated group must still determine their own taxable income. The taxable income of each group member is combined, subject to some adjustments, to determine the group's overall tax liability.[17]

Adjustments to cost base

25. Because each member of a consolidated group is required to calculate their own income and loss, the sale of one of the group companies during an income year can give rise to the same double taxation and double deduction issues as for other group companies.

26. This issue should be resolved by adjusting the cost base for each consolidated group member annually. The adjusted cost base would be calculated as follows:
    - opening cost base, plus
    - any contributions to the capital of the group member during the year, plus
    - any taxable income of the group member as determined under the consolidation rules, less
    - any distributions made by the group member during the year, less
    - any taxable loss of the group member, as determined under the consolidation rules.

27. As for the rules for loss transfers within corporate groups, described above:
    - adjustments to the cost base of shares must be mirrored up a chain of companies
    - the adjustment should be made at the end of the income year or immediately before a group company is sold, and
    - the cost base of a group company's shares cannot be less than zero.

Intra-group transactions

28. Transfers of included assets between members of a wholly-owned group, which would include transfers within a consolidated group, should be subject to rollover treatment, i.e. the transaction will be ignored and the new owner will inherit the original cost base of the asset. When transfers within a group are not made at market value, the rules for calculating deemed dividends or deemed capital contributions should apply and appropriate adjustment to the basis of shares should be made. Transactions between consolidated group members, more generally, are also ignored for income tax purposes under the current consolidation rules.

29. The application of these rules should be given further consideration to ensure they will not give rise to any unintended consequences under an extension of the taxation of capital gains.

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17 As noted in paragraph 4, Australia has a different regime for consolidated groups where the shares of subsidiaries are ignored and adjustments similar to these aren't required. The Government should consider whether New Zealand should follow this approach.

11

Other issues

1. The Group recognises there are many other issues that will need to be considered in determining how an extension of the taxation of capital gains will integrate with current tax legislation. In particular, the following rules are likely to be affected:
   - rules for taxing revenue account property, including the rules around deductibility of holding costs
   - rules for taxing land sales
   - finance lease and share swap rules
   - bad debt rules, particularly the restrictions on deductions in some cases
   - rules for share cancellations and repurchases and treasury stock rules
   - rules dealing with shares for share exchanges and share lending
   - company amalgamation rules
   - employee share schemes and options rules
   - livestock rules, in particular, the herd scheme rules
   - other industry regimes that take a revenue account approach, e.g. petroleum and mineral mining, forestry and films.
2. Consideration should also be given to rules that New Zealand does not presently have but that have been introduced in Australia for anti-avoidance. One example is the value shifting rules, where interests in assets are changed so as to shift value from an owner to a user without a realisation occurring. We expect that many other issues will also be identified through industry and stakeholder consultation and through the Generic Tax Policy Process.