Tax Working Group Information Release

Release Document

September 2018

taxworkinggroup.govt.nz/key-documents

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The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the Group or the Government.

Coversheet: **Extending the taxation of capital income**

Discussion Paper for Session 8 of the Tax Working Group
May 2018

Purpose of discussion

This paper sets out the main judgements and choices involved in extending the taxation of capital income. It also sets out the advantages and disadvantages of the main options for taxing capital gains, so that all Group members have a clear sense about what is at stake in the detailed design work that will be undertaken by the Subgroup. This is initial advice that will be refined further as design work progresses and the results of modelling become available.

Key points for discussion

- Is the Group comfortable with the approach set out in the Forward Agenda for considering extensions to the taxation of capital income?
- Does the Group wish to provide any high-level parameters to guide the Subgroup's work on detailed design issues?
- Does the Group wish to rule out any design options before the Subgroup begins its work?

Recommended actions

We recommend that you:

a **note** that the Forward Agenda currently includes the following items on capital income:

Date	Meeting	Item
4 May	Meeting 8	Discussion on taxation of income from capital gains.
1 June	Meeting 10	Report back from Subgroup.
15 June	Meeting 11	Options assessment: land tax / RFRM / capital gains options arising from the Subgroup's work.

b **indicate** whether the Group is comfortable with the approach in the Forward Agenda.

c **indicate** whether the Group wishes to provide any high-level parameters to guide the Subgroup's work on detailed design issues, such as:

i. The coverage of assets.
ii. Accrual vs. realisation basis.
iii. Full vs. reduced rates.
iv. The treatment of losses.

d **indicate** whether the Group wishes to rule out any design options before the Subgroup begins its work.

Extending the Taxation of Capital Income

Discussion Paper for Session 8
of the Tax Working Group

May 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

Purpose

This paper sets out the main judgements and choices involved in extending the taxation of capital income. It also sets out the advantages and disadvantages of the main options for taxing capital gains, so that all Group members have a clear sense about what is at stake in the detailed design work that will be undertaken by the Subgroup. This is initial advice that will be refined further as design work progresses and the results of modelling become available.

A patchwork of taxation

Many gains are already taxed, but some are not. The current approach to taxing capital gains is therefore something of a patchwork, giving rise to significant fairness and integrity challenges. A more consistent approach to the taxation of capital gains could improve the fairness, integrity and (in some respects) efficiency of the tax system, but would also generate other economic costs and risks, and give rise to higher administration and compliance costs.

Strategic choices: targeted vs. broad-based approaches

In light of these costs and benefits, there are two broad approaches that the Group could take.

- A *targeted* approach of bringing certain asset classes into the tax net that are relatively easy to tax and that would go a long way towards improving the fairness and integrity of the tax system.

- A *broad-based* approach of including as many asset classes as practicable in the tax net.

The importance of detailed design choices

It is difficult to make this choice in the abstract. This is because the extent to which the costs and benefits of taxing capital gains are realised will depend heavily on detailed design choices. It is therefore necessary to develop a concrete, worked-up set of options that can be assessed against each other.

The main choices relate to *what to tax* (what assets will be covered by the tax regime) and *how to tax* (whether to tax on an accrual or realisation basis; what rate of tax to impose; and whether to ring-fence capital losses). A host of second-order design issues then flow from these choices, and particularly from a decision to introduce a realisation-based tax.

Next steps

Subject to any direction from the Group, the next step is for the Subgroup to work up a set of options that could be the subject of more granular assessment. The Secretariat understands that the options for assessment will include a broad-based capital gains tax (excluding the family home) and potentially some targeted options for expanding the capital/revenue boundary. In the case of land, the options will be compared against the risk-free rate of return method (RFRM) and land taxes. The Subgroup will report back on its work on 1 June, and the full set of options will be discussed on 15 June. During this time, more work will be necessary to understand the impact of the options on Māori interests.

1. Introduction

1.1 Purpose

1. This paper sets out the main judgements and choices involved in extending the taxation of capital income. It also sets out the advantages and disadvantages of the main options for taxing capital gains, so that all Group members have a clear sense about what is at stake in the detailed design work that will be undertaken by the Subgroup.

2. The paper also sets out the Secretariat's initial views on the design issues in Appendix D. This is initial advice that will be refined further as design work progresses and the results of modelling become available.

1.2 Structure

3. The paper has the following structure:

    - Chapter 2 introduces the overall judgements facing the Group on this subject.
    - Chapter 3 describes the current tax treatment of gains and losses.
    - Chapter 4 outlines the main strategic choices facing the Group.
    - Chapter 5 explores the implications of progressively extending the coverage of assets by the tax regime.
    - Chapter 6 identifies three issues that are central to the design of any regime for taxing capital gains: whether to tax on an accrual or realisation basis; what rate of tax to impose; and whether to ring-fence capital losses.
    - Chapter 7 identifies a range of important second-order issues that also require attention.
    - Chapter 8 outlines the distributional impacts of taxing capital gains.
    - Chapter 9 outlines compliance and administration considerations.
    - Chapter 10 outlines the interactions between the taxation of capital gains and other measures for business tax reform.

4. There are five appendices:

    - Appendix A outlines the Secretariat's thinking on risk-taking and capital gains taxes.
    - Appendix B summarises the current tax treatment of gains and losses.
    - Appendix C provides a cross-country summary of regimes for taxing capital gains.
    - Appendix D outlines the Secretariat's initial views on the main design issues.
    - Appendix E summarises the findings of recent New Zealand reviews on this subject.

1.3 Assessment frameworks

5. The paper assesses the efficiency, fairness, integrity, administration and compliance, and revenue impacts of the choices. Efficiency impacts link directly to physical and financial capital, while fairness and integrity impacts provide an insight into impacts on social capital. The links between capital income taxation and human and natural capital are less direct and harder to assess. Nevertheless, it is recognised that specific issues are likely to have a particular impact on natural capital or Māori interests.

2. Overall judgements

6. In order to decide whether to extend the taxation of capital income, the Group will need to form an overall judgement:

> In broad terms, will the **fairness, integrity, revenue, and efficiency benefits** from reform outweigh the **administrative complexity, compliance costs, and efficiency costs** that arise from taxing capital gains?

7. The extent to which these benefits and costs are realised will depend on policy design. This means the Group will need to conduct an iterative assessment process, circling back to consider broader impacts as choices are made about specific design features. The way that additional revenue is 'recycled' (for example, to offset or mitigate the economic costs of taxing capital) will also be very important for assessing the net impacts of policy change.

8. This chapter outlines the main considerations for and against reform, to give a sense of the main issues at stake as the Group begins to form its views.

2.1 Fairness

9. A sense of fairness is central to maintaining public trust and confidence in the tax system. This is because a system that distributes the costs of taxation in a way that is perceived to be unfair will generate resentment and undermine social capital. Perceptions of unfairness will erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance that underpins efficient tax collection.

10. The tax system is inconsistent in its treatment of capital income because it does not generally tax gains from the disposal of capital assets. This inconsistent treatment compromises commonly-understood notions of fairness in two ways:

    - **Horizontal equity.** Individuals earning the same amount of income face different tax obligations, depending on whether they earn capital gains or other forms of income.

    - **Vertical equity.** Higher income individuals and households tend to derive a greater proportion of their income from selling capital assets than lower income individuals and households. The current approach can be regressive if it results in lower tax obligations on those with greater economic capacity to pay.

11. Reform could reduce inconsistency in the treatment of individuals and increase the progressivity of the tax system. This will, however, require an assessment of the economic incidence of tax reform – particularly in the housing market, where tax reform is likely to have differing impacts on homeowners, landlords, and tenants. Not all of the economic incidence of a tax on capital gains is likely to fall on those who are subject to the tax; some of the incidence may be passed on to others, such as tenants through higher rents.

2.2. Integrity and base protection

12. The current treatment of capital income creates opportunities for tax planning and avoidance. Some of the challenges we currently face include:

- **Dividend stripping.** Shareholders who wish to extract money from a company without receiving a dividend sometimes attempt to do so by selling the company to a second company, in which they hold shares. If the second company owns 100% of the first company, the first company's assets can be distributed to the shareholder free of tax, in payment of the purchase price owed by the second company to the shareholder. Anti-avoidance rules treat such sales as dividends for tax purposes, but the rules can be uncertain and resource-intensive to apply. There would be less of a need for the rules if the shareholder were subject to tax on the profit from sale.

- **Incentives to classify on capital account.** In business asset sales, some of the assets are on capital account (e.g. land and goodwill), while others are on revenue account (e.g. trading stock). Since gains on capital account assets are not taxed, the vendor has an incentive to allocate more of the selling price to capital account assets.[1] The motivation for such activity would greatly reduce if tax applied to the gains on sale from all types of assets, so the entire gain was taxable at the same rate. (The purchaser, however, would still be motivated to allocate more of the price to assets where the cost is immediately deductible.)

- **Incentives to re-characterise labour income as capital income.** The current system is challenging in terms of the boundary between labour income and capital gains. For example, suppose a person acquires a small and dilapidated commercial building. They spend a month of their own time repairing the building, then rent it out for two years, during which time they maintain it and make various improvements. The building is then sold for a significant gain. A large portion of this gain will reflect the return to the person's labour, and should be taxed. However, in the current system, it is almost certain to be treated as an untaxed capital gain. Other examples include start-up businesses and one-person companies where individuals work for no or below-market wages. If the company is sold for a gain, much of the gain may be labour income in substance, but is likely to be treated as a capital gain in practice.

13. Extending the taxation of capital gains could support the integrity of the tax system by reducing opportunities for tax planning and tax avoidance. The extent to which it does so in practice, however, will depend heavily on the details of policy design. In general, design choices that reduce the distinction between capital gains and other forms of income will increase the integrity of the tax system – but it is not always possible to arrive at this ideal position in the course of policy design.

2.3 Revenue

14. The current tax system relies heavily on three tax bases: personal income tax, company income tax, and GST. Taxing more capital gains would broaden the base. The additional revenue could be used to increase the Government's flexibility for dealing with future challenges, or pay for other revenue-reducing reforms.

15. The revenue volatility from taxing capital gains will pose challenges for fiscal management. The direct macroeconomic impact will be counter-cyclical: tax revenue will increase as asset prices rise, and reduce as asset prices fall.

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[1] The purchaser may take an inconsistent position, or the vendor's allocation may not affect the purchaser.

16. In general, asset price movements tend to be correlated with economic cycles. However, volatile tax revenues could lead to a pro-cyclical response in government spending. In an asset price boom, for example, buoyant tax revenues could lead the Government to increase spending or cut other taxes. A subsequent economic downturn and asset price crash could result in the emergence of large fiscal deficits, leading the Government to cut spending or raise taxes, which would exacerbate the economic downturn. This pro-cyclical dynamic contributed to the Irish fiscal crisis of 2008. The lesson is that capital income tax reform needs to be accompanied by fiscal institutions that can manage greater revenue volatility.

17. The revenue impact of a capital gains tax will depend on the design of the tax, as well as behavioural responses and movements in asset prices. The Secretariat has modelled a capital gains tax that applies to all types of land (excluding the family home) and domestic shares. Assuming annual appreciation of 3% across all types of assets, the tax is modelled to raise over 1% of GDP in the tenth year after introduction. This modelling assumes that all losses are immediately deductible.

2.4 Efficiency

18. The economic impacts of capital income taxation are complex to assess because there are a range of effects that move in different directions. The following analysis begins with an assessment of the overall economic impacts of capital gains taxes, and then explores a number of specific channels through which capital gains taxes could affect economic activity.

Box 1: How do capital gains taxes affect productivity, investment, and growth?

The Secretariat has reviewed the literature on the overall economic impacts of capital gains taxes. Grubel (2001) summarises the main challenges in assessing these broader impacts:

> *It is very difficult… to make reliable, reproducible, quantitative estimates of the direct effects of capital gains taxation on productivity and living standards. In Canada and other economies there are too many other influences operating on productivity and output. These confounding influences are a function, for example, of the level and structure of the personal and corporate income taxes, the effects of terms of trade, environmental legislation and other regulations, labour market flexibility, inflation, interest rates, and shocks like the energy crisis. There are not enough observations and too few changes in the rate of taxation, and the interrelationships are too complex to permit separating out the effects of high capital gains taxes on economic growth in Canada.*

Most economic analysis of capital gains taxes therefore tends to focus on the extent of lock-in, rather than broader impacts on productivity, investment, and growth. The literature that does cover these broader issues tends to rely on first principles analysis rather than empirical evidence.

The literature generally suggests that capital gains taxes are unlikely to have a material impact on productivity, investment, or growth at an economy-wide level. This is especially so in an open economy like New Zealand. After reviewing the literature and theory, Zodrow (1995) states:

> *The results obtained in these closed economy models are sufficiently small that it seems highly unlikely that similar changes in a partially open economy context – in which saving incentives have relatively little effect on the cost of capital and changes in saving do not translate automatically into changes in investment – would result in significant changes in saving, investment and economic growth.*

Sources: Auerbach (1992), Auten and Cordes (1991), Clemens *et al* (2014), Coleman (2010), David (1964), Engen and Skinner (1996), Fazzari (1998), Gravelle (1994), Grubel (2001), Huang (2012), Hungerford (2010), Johansson *et al* (2008), Poterba (1989), Stiglitz (1983), Veldhuis *et al* (2007), Wallich (1965), Zodrow (1993), Zodrow (1995).

19. Within this context, there are five channels through which capital gains taxes might affect the economy:

2.4.1 Levels of investment

20. Increasing the taxation of capital income is likely to increase effective tax rates on some investments, and thereby reduce levels of investment. By itself, this is likely to have a negative impact on productivity and economic growth. As noted in *Box 1*, however, it is difficult to find evidence that capital gains taxes have a major impact on investment.

2.4.2 Allocation of investment

21. The inconsistent treatment of capital income biases decision-making towards investments that generate untaxed capital gains. This is likely to result in an inefficient allocation of investment across the economy (for example, in favour of investment in land over other types of assets). In principle, reform could enhance efficiency by correcting this distortion, although the extent to which it does so will depend on the extent of coverage and the design of the tax regime.

22. The Secretariat is unaware of evidence that quantifies the impact of capital gains taxes on resource allocation across economies. But there is some evidence that tax distortions *more broadly* are associated with resource misallocation across firms and industries (or, in other words, labour and capital not flowing to the most productive firms and industries). The International Monetary Fund (2017) estimates that reducing resource misallocation across firms could translate into higher annual economic growth of around 0.7 percentage points over twenty years on average across advanced economies (with the caveat that much of this resource misallocation will be caused by factors outside of the tax system).

2.4.3 Impacts on entrepreneurship and risk-taking

23. The design of a tax on capital gains creates some important economic risks. The primary risk relates to the treatment of capital losses. Most countries that tax gains and losses have restrictions on the deductibility of losses in order to protect the tax base. An asymmetric treatment of losses and gains, however, could have damaging economic effects by discouraging entrepreneurship and risk-taking.

24. The extent to which the tax base needs to be protected depends on a key assumption: that most entrepreneurial losses are not deductible as ordinary losses. However, it seems likely that in many cases such losses are deducted as ordinary losses. For example, regular expenses such as salaries and rent may generally be deducted, even when incurred by a company that is heavily engaged in the development (rather than operation) of its business.

25. There is no easy way to test the extent to which losses of capital from entrepreneurial activity are already in the tax base. Further information about entrepreneurial practice could be revealed through public consultation on the interim report.

2.4.4 Lock-in

26. Taxing capital gains on a realisation basis also creates a risk of lock-in. Lock-in describes a situation where is an investor is unwilling or unable to dispose of an asset due to the tax liabilities that will crystallise when the asset is disposed. Lock-in is usually cited as one of the key efficiency costs of a realisation-based capital gains tax.

Box 2: How big a problem is lock-in?

In 2009, officials' advice to the Victoria University of Wellington Tax Working Group questioned the extent to which lock-in is likely to be a problem in practice:

> *The extent to which lock-in actually occurs in practice is much less clear. According to Burman and White (2003), the literature indicates that lock-in may not be as much of a problem as is often suggested. For example, if lock-in was a significant issue, then asset realisations would be very sensitive to the rate of tax. However, studies from the United States have found that gains are not very sensitive to tax rates (Auerbach 1989). Burman and Randolph (1994) explore responses to permanent and temporary changes in tax rates on capital: they find that permanent changes in tax rates have little or no effect on realisations, whereas there may be a large response to temporary rate changes.*

The Secretariat has reviewed the recent literature on this subject. The results are mixed. A number of more recent studies find the effects of lock-in to be temporary and/or marginal, and confirm that there are larger responses to temporary rate changes than permanent changes.

But a sizeable body of literature has also emerged to suggest that lock-in may be a real problem. This literature draws upon empirical evidence from corporate mergers and acquisitions, shares, housing, and new businesses.

In the Secretariat's view, the weight of evidence suggests that lock-in remains a relevant concern in the design of capital gains taxes, but it is not possible to quantify the economic impacts.

Sources: Aregger *et al.* (2013), Chari *et al.* (2005), Dai *et al.* (2006), Caro and Cebada. (2016), Dimmock *et al.* (2018), Feld *et al.* (2016), Hegemann *et al.* (2015), Hoyt and Yelowitz (2016), Jacob (2016a, 2016b), Dowd *et al.* (2015), Niemann and Sureth (2013), Slemrod *et al.* (2016).

2.4.5 Macroeconomic stability

27. Theory suggests that a capital gains tax will have a one-off impact on asset prices on introduction (or announcement), and that it could also dampen asset price cycles. The size of these effects, however, may be small.

Box 3: What does the evidence tell us about capital gains taxes and asset prices?

Empirical evidence for these impacts is unclear. There are two main reasons why:

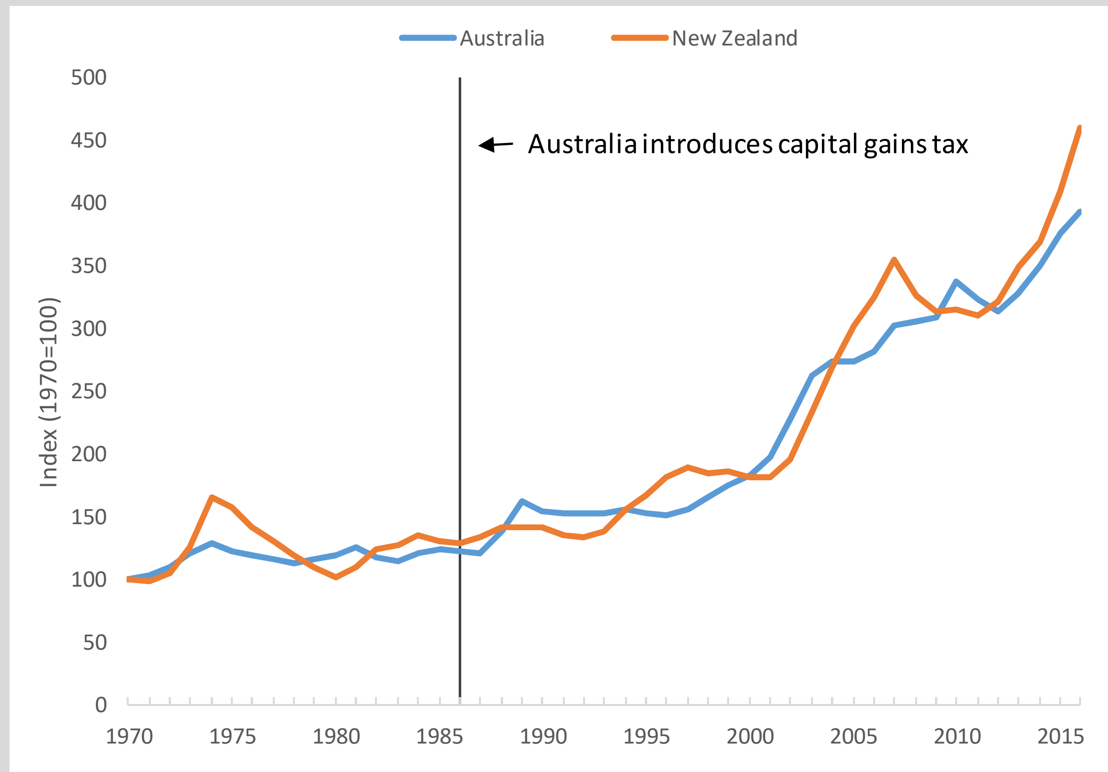
- Results are highly context-dependent: the impacts depend on broader market dynamics and institutional settings, as well as the design of the tax.
- It can be technically challenging to isolate the impact of the capital gains tax alone, given the range of other variables that affect asset prices.

Some empirical evidence from the United States indicates that capital gains taxes can reduce volatility in the stock market. Empirical evidence from Switzerland, on the other hand, indicates that capital gains taxes exacerbate house price dynamics (primarily due to lock-in effects).

The behaviour of house prices in New Zealand and Australia suggests that capital gains taxation has had only a small impact on the housing market. Australia introduced a capital gains tax in 1985. Its house price index decreased by 3% in real terms between 1985 and 1987 (although it

increased rapidly in 1987), compared with a 1.5% increase in New Zealand over the same period. The broadly similar behaviour of house prices in Australia and New Zealand over the last few decades, despite different tax regimes, suggests that tax policy has not been a major factor in house price movements. This is perhaps unsurprising in light of the fact that Australia's capital gains tax regime excludes owner-occupied homes.

Figure 1: Real house prices in Australia and New Zealand, 1970-2016



Sources: Aregger *et al.* (2013), EU (2011), RBA (2004), Shen (2015), Shi *et al.* (2016) and Wan (2017). Data source: OECD.

2.4.6 An overall assessment of efficiency impacts

28. The overall efficiency impact of extending the taxation of capital income is uncertain. Three major findings emerge from the work conducted by the Secretariat:

- Theory suggests that economic efficiency will be enhanced if the benefit of reducing investment distortions outweighs the costs of lock-in and reduced investment and entrepreneurship. The extent to which this occurs in practice will depend heavily on policy design.

- The Secretariat has not found empirical evidence to suggest that the taxation of capital gains will have large impacts on investment, productivity, and growth at the economy-wide level. The impacts by sector, however, may vary.

- The way that additional revenue is 'recycled' will be important to assessing the net efficiency impacts of policy change.

29. Public consultation on the interim report could be used to test these findings and assess whether there are likely to be disproportionate impacts on particular sectors and industries.

2.5 Administration and compliance

30. The extension of capital income taxation will increase compliance and administration costs; the administrative complexity of a broad-based capital gains tax, in particular, should not be underestimated.

31. The Tax Review 2001 (known as the McLeod Review) noted that capital gains tax regimes tend to be one of the most complex areas of tax law in the jurisdictions that have capital gains taxes. Moreover, unlike most other complex areas of tax law, the capital gains rules must be interpreted and applied by 'ordinary' taxpayers. The McLeod Review identified a number of consequences that flow from this fact:

    - The taxes are often perceived by taxpayers as being unfair or unreasonable.

    - As legislatures seek to dispel these concerns, capital gains taxes tend to be subjected to more legislative change than other areas of tax law, making the law more uncertain and, often, resulting in increasing arbitrariness in the application of the law.

    - As exemptions and complexity increase over time, capital gains taxes can end up imposing compliance costs that appear disproportionate to the amount of revenue raised.

    McLeod *et al*. (2001)

32. The McLeod Review ultimately decided that the design compromises necessary to ensure the acceptability of a broad-based capital gains tax would undermine the efficiency of the tax.

2.6 Conclusion

33. This chapter has briefly sketched out some of the key considerations for and against reform, but the extent to which these benefits and costs are realised in practice will depend entirely on policy design. This means the Group will need to conduct an iterative assessment process, circling back to consider broader impacts as choices are made about specific design features. The way that additional revenue is 'recycled' will also be important to assessing the net impacts of policy change.

34. The following chapters of this paper provide greater detail on the main choices before the Group, as an input into the Group's judgements on these matters.

3. The current treatment of gains and losses

35. This chapter describes the current tax treatment of gains and losses. It sets out which gains are taxable, and which are exempt, to help the Group identify the gaps and anomalies in the current treatment of capital income.

3.1 General principles

36. Much capital income is already taxed. Interest, rents, royalties, and receipts earned in the ordinary course of business are already subject to income tax. However, there is a significant element of capital income which is not taxed – generally, receipts which are not earned in the ordinary course of business, which are often from the sale of capital assets.

37. Current income tax law is founded on a distinction between income gains and expenditure (which are taxed and deductible) and capital gains and expenditure (which are exempt and non-deductible). In principle, gains derived in the ordinary course of carrying on a business are taxable, and other gains are generally exempt.[2] In practice, it is often difficult to draw this distinction, because it depends on judgements about a person's intentions, the nature of their business, and the role of a particular asset, liability or payment within that business.

38. New Zealand already taxes some payments that used to be treated as capital payments. The rationale for doing so, in general, is that these payments are particularly substitutable for income. Examples of taxable capital gains include: lease inducement and surrender payments; restrictive covenant payments made to a contractor or employee; proceeds from the sales of bonds, derivatives and other financial instruments (not including shares); proceeds from the sales of patents; proceeds from the sale of all assets used in petroleum mining; and gains from certain land sales.

39. Sometimes tax avoidance law applies to tax a capital gain. For example, some share sales are taxable on the basis that they are actually disguised dividends. In this case, the basis for taxation is a judgement that, in substance, the gain 'should' be taxed – even if the ordinary application of the law would place the gain on capital account.

3.2 Specific asset classes

3.2.1 Land

40. Gains on the sale of land are taxable if the land was bought with the purpose or intention of resale, even if resale was not the only or dominant purpose or intention of the purchase. Capital losses are generally not deductible unless a gain on the sale of the property would be taxable.

41. The bright-line test aids the enforcement of this rule. It serves as a proxy for 'purpose of disposal' – which can otherwise be difficult to enforce – by taxing the sale of any residential property within five years of purchase, subject to some exceptions.[3] The most important exception is that the family home is excluded from the test.

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[2] This includes gains from a single profit-making venture.
[3] The Government passed legislation in March 2018 to extend the bright-line test from two to five years.

42. Capital gains on owner-occupied homes are not generally taxed. This can be rationalised on the basis that the purpose of acquiring a family home is generally to live in it, and the prospect of resale is sufficiently secondary that it can be ignored. There are some exceptions: the ‘main home’ exclusion from the bright-line test can only be used twice in a two-year period; and owner-occupiers with a regular pattern of buying and selling their own home are subject to most of the land sale rules, including the bright-line.

43. Land affected by changes to zoning, consents, or other specified changes may be taxed on sale, if the sale is within ten years of acquisition. If at least 20% of the gain on disposal can be attributed to the change, the whole gain is taxable. However, the taxable amount is reduced by 10% for each year the taxpayer has owned the land.

44. Land disposals may be taxed if an undertaking or scheme involving more than minor development or division of the land was commenced within ten years of the land being acquired. Land disposals may also be taxed if there has been a scheme of division or development of the land that involves significant expenditure on specified works, subject to a number of exclusions.

45. Most of the land sale rules represent attempts to codify or buttress common law principles that would have made land sales taxable in any event. Because the principles are factually dependent, however, the rules also tend to be factually dependent, and have given rise to much uncertainty and litigation. They are also difficult to enforce at a practical level.

3.2.2 Shares in New Zealand companies

46. Gains on shares are only taxable if they have been acquired for the dominant purpose of disposal, or in the course of a person’s share dealing business. Shares are otherwise held on capital account, and gains on those shares are not taxable.

47. In practice, it can be difficult to determine the dominant purpose of acquisition, or whether a person is a share dealer who acquired the shares in the course of their business. Although most people acquire shares with a view to selling them at some later time for a profit, this fact is insufficient by itself to satisfy the ‘dominant purpose’ test.

48. Enforcement is exceedingly difficult. Unsurprisingly, taxpayers tend to take the view that they have not acquired shares with a purpose of resale; the case law is extensive and contains many decisions that taxpayers can use to justify a revenue-unfavourable outcome. It is costly for Inland Revenue to challenge individual cases. The law also gives rise to considerable uncertainty for taxpayers, and it can be costly for taxpayers to defend if Inland Revenue decides to audit a transaction.

49. Several aspects of the regime for taxing companies and shares in companies are worth exploring in more detail:

- **The role of company income tax.** The taxation of company income means that tax is paid, at least to some degree, on the gains on shares as they accrue. Accruing gains on shares will *not* be taxed if they reflect capital gains accruing in or realised by the company, foreign-sourced income earned through foreign subsidiaries, or any other share price increase that is unrelated to the retention of tax-paid income.[4] If one assumes that an integrated corporate tax system is the 'correct' approach, the company income tax rate will be inappropriate when a shareholder's marginal personal tax rate is 33%.

- **Shares held by portfolio investment entities (PIEs).** Gains on shares held by PIEs are not taxable. This treatment is a response to the fact that gains on shares held by individuals are in practice rarely taxable, whereas gains on shares held by managed funds are almost always taxable as business profits. Applying this approach to PIEs would have created a bias against the use of managed funds for equity investment, so managed funds operating as PIEs were exempted from taxation on the sales of New Zealand shares.

- **Non-portfolio professional investors.** There is technical uncertainty regarding the treatment of share sale gains and losses by angel, venture capital, and private equity investors. In practice, gains to these investors are rarely taxable and losses are not deductible.

3.2.3 Shares in foreign companies

50. The fair dividend rate (FDR) method is used to tax portfolio investment in foreign shares. FDR is a form of accrual-based taxation of income, inclusive of capital gains and dividends. Shares are generally taxed on a 5% deemed return, based on the opening value of the shares in each year. Actual dividends and sale proceeds are not taxed. However, in any given year, individuals and family trusts can pay tax on the actual return from their foreign share portfolio (including accruing gains and losses) if it is lower than the deemed return.[5]

51. FDR is intended to raise revenue while reducing the bias against equity investment through managed funds. For domestic shares, this bias was dealt with by exempting PIEs from tax on gains from sale. But this approach would be problematic in relation to foreign shares. Since the income of foreign companies is not taxed unless it is earned in New Zealand, and such companies often do not pay large dividends, a failure to tax the gain on sale would allow most of the return from the investment to escape the domestic tax system. The solution was to tax both individuals and funds, but on a modified basis.

52. The following approaches apply for direct investment in more than 10% of the non-resident company:

[4] Inland Revenue data indicates that public companies are not generally accumulating imputation credits. This suggests public companies tend to distribute all of their taxed earnings, so drivers other than the accumulation of taxed earnings must account for share price appreciation. This is not inconsistent with a view that the company valuation reflects expectations of future cash flows.

[5] Tax is only imposed on gains and dividends from shares in Australian-listed companies if they are taxable under the capital/revenue test. There are also some situations where tax is imposed on all capital gains from shares on an accrual basis.

- **Controlled foreign companies (CFCs).** The capital/revenue distinction applies to controlled foreign companies, with the result that most gains on sale are not taxable and most losses are not deductible.

- **Other types of direct investment.** In other cases, the shareholder can generally choose between treating the investment as a portfolio investment or as shares in a CFC.

3.3 Capital losses and expenses

53. The capital/revenue test applied by the courts denies deductions for capital expenses, but deductions are allowed by statute for many types of expenditure that would otherwise sit on capital account. These include deductions for depreciation and the cost of acquiring standing timber. Depreciation deductions initially applied only to tangible property, but have been extended to apply to many forms of wasting intangible property, such as computer software, and even to the costs associated with unsuccessful attempts to acquire certain types of property.

54. No deductions are allowed for feasibility expenditure or the cost of acquiring goodwill. Building depreciation deductions were abolished in 2010.

3.4 Conclusion

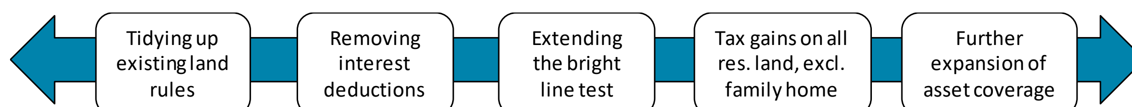
55. The current tax treatment of capital income is a patchwork. Much capital income is taxed, but income from the sale of capital assets is often not taxed. The most significant forms of capital income that are currently outside the tax net are gains from the sale of land, shares (other than portfolio investment in non-resident companies), businesses, and intellectual property, where those assets have been acquired for the purpose of use rather than sale. A summary table of the current tax treatment is attached at Appendix B.

4. Strategic choices

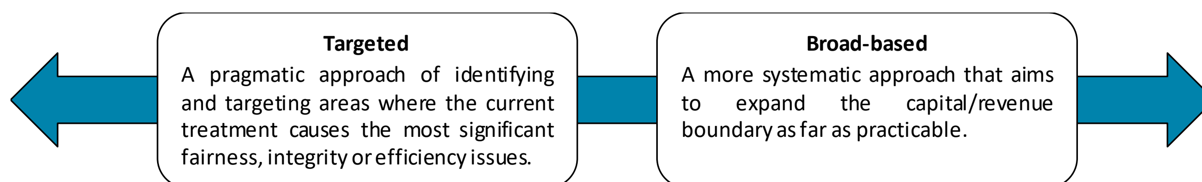
56. This chapter sets out the main strategic choices for extending the taxation of capital income to include more capital gains.

4.1 Targeted vs. broad-based approaches

57. The Group is not limited to a binary choice between taxing all capital gains and taxing none. As we have seen, some gains are already taxed. During discussions to date, Group members have also identified a spectrum of options for progressively extending the taxation of capital income. These options include:



58. Underlying these options is a broader choice about the approach the Group wishes to pursue.



59. Under a targeted approach, the Group could recommend bringing some assets into the tax net that are relatively easy to tax, on the basis that including these assets will go a substantial way towards addressing the challenges we currently face. Alternatively, the Group could recommend taxing only certain types of gains, such as short-term gains or expected gains. This paper focusses on the possibility of targeting certain types of assets or (to a lesser extent) time periods. Further analysis on other options could be commissioned at the Group's direction.

60. A targeted approach does have its downsides. The most significant problem is that the inconsistent treatment of assets will reduce horizontal equity and distort investment choices. There will also be continuing integrity challenges as taxpayers seek to push their gains onto capital account.

61. Accordingly, the Secretariat would suggest that a targeted approach should only be adopted where the boundary is: (i) as clear as possible; (ii) does not leave easily substitutable assets on either side of the line; and (iii) can be policed with a minimum amount of effort.

62. The decision will also be affected by any Group recommendations regarding other forms of taxation for certain assets, such as a land tax.

4.2 Design issues

63. The following three chapters explore the design issues associated with the extension of capital income taxation to include more capital gains:

- Chapter 5 explores the implications of progressively extending the coverage of assets by the tax regime. This could be characterised as 'what to tax.'

- Chapter 6 identifies three issues that are central to the design of any regime for taxing capital gains: whether to tax on an accrual or realisation basis; what rate of tax to impose; and whether to ring-fence capital losses. These issues could be characterised as 'how to tax.'

- Chapter 7 identifies a range of important second-order issues that also require attention.

64. The chapters are sequential, but the design of any tax regime is, by necessity, iterative. The paper attempts to minimise repetition in the following chapters, but does note where design choices intersect and influence each other across the chapters.

5. Extending the coverage of asset classes

65. This chapter considers how to expand the universe of assets that are subject to tax on gains from sale. It starts with certain types of land, and then moves progressively outwards.

5.1 Non-owner-occupied residential land

66. Some residential land sales are already taxed, and the introduction of the bright-line test means that a number of design issues associated with taxing such land have already been addressed. The test already provides:

   - A definition of non-owner-occupied residential land (although it might be necessary to refine the definition if it is considered too expansive once the test has been extended).
   - Avoidance provisions that prevent taxpayers from avoiding the tax by transferring their interests into landowning trusts or companies (although the provisions are relatively simple and will probably require elaboration if the test is extended).
   - A withholding tax to ensure tax is collected when the vendor is a non-resident. (The withholding tax could potentially be extended further.)
   - Limited roll-over relief so that tax is not imposed when property is transferred on death or relationship break-up.
   - Loss ring-fencing provisions to prevent taxpayers using a loss on a sale that is taxable under the test against other income.

67. Two options for extension that could be considered are to extend the bright-line test (say, to ten years), or to remove the time-limit altogether. Both options will mark a philosophical shift. The current test aims to discourage short-term speculative activity in the housing market, whereas an extended test will serve a more explicit base-broadening purpose.

5.1.1 Economic impacts

68. The economic impacts of covering all non-owner-occupied residential land are likely to be mixed. Increasing taxes on rental property will discourage investors from the housing market and reduce house prices to some degree. Increasing taxes could also affect the cost of rental housing. The extent to which costs are passed through to tenants, rather than absorbed by landlords, is unclear. On a first-principles basis, we would expect to see the following results:

   - If there is no distinction in the taxation of owner-occupiers and landlords, and supply is fixed in the short-term and largely unresponsive in the long-term, then house prices will fall, with no impact on rents. This is because demand for housing from both owner-occupiers and landlords will fall in response to lower after-tax returns, while supply remains unchanged.

- If owner-occupiers are exempt from the additional taxation, the value of houses will increase for owner-occupiers and fall for landlords. The supply of rental housing will fall as landlords exit the market. The demand for rental property will also fall as some renters become owner-occupiers – but not at the same rate, because rental properties tend to have higher occupancy rates than owner-occupied properties. The net effect is likely to be a modest increase in rental yields, made up of some combination of falling prices and increasing rents.

69. There is little definitive empirical evidence regarding the impact of tax changes on housing market indicators. The Secretariat has commissioned economic modelling to estimate the housing market impacts of capital gains taxation. The results of this modelling will be available by July.

70. There is some analysis available on the impact of the bright-line test. Inland Revenue has reviewed tax returns and Land Transfer Tax Statement data for the period 1 October 2015 to 31 March 2016. Of the analysed transfers:

- 2,700 (or 67.5%) appear to be exempt.
- 300 (or 7.5%) appear taxable under the two year bright-line test.
- 1,000 (or 25%) are taxable under other provisions.

71. There is no evidence yet on the impact of extending the test to five years. However, extending the test to all property, regardless of the time held, will change the incentive to hold property for particular periods of time. A tax with no fixed time period will create some degree of lock-in, but it will also reduce the current very strong incentive to hold property for at least five years until sale.

5.1.2 Compliance, administration, and integrity impacts

72. It will be relatively straightforward, from an administrative perspective, to extend the bright-line test to catch sales of all non-owner-occupied residential property. Extension is even desirable in some respects, since it will simplify the law applying to such sales (such as the ten-year rule discussed in Chapter 3).

5.2 Commercial and industrial land

73. If non-owner-occupied residential land is folded into the capital income taxation regime, the next step that could be taken is to extend the regime to commercial and industrial land.

5.2.1 Economic impacts

74. The main rationale for taxing gains on commercial and industrial land is to reduce any distortions arising from the inconsistent treatment of different types of land. A tax on only one type of land will discourage that use. Depending on after-tax returns, for example, there could be a disincentive to rezone commercial and industrial land into residential land in circumstances where it would otherwise be efficient to do so. Including gains on all land within the tax net would avoid that distortion.

75. One of the key economic issues associated with taxing gains on this asset class will be the treatment of gains and losses attributable to buildings and other improvements. This could have a large impact on the quantity of investment in the sector. Recognising gains and losses on buildings will allow losses to be claimed when buildings are scrapped, which will take account of the real losses faced by some taxpayers. It will also make the tax treatment of buildings more consistent with the tax treatment of depreciable assets.

5.2.2 Compliance, administration, and integrity impacts

76. There will be an increase in compliance and administration costs for the owners of commercial and industrial land. The design of the extension will also need to account for integrity risks. There will be a high risk of avoidance through the use of companies and trusts, particularly when the vendors are non-residents, unless rules are in place to counter this risk.

5.3 Farming, forestry, and mining land

77. In principle, one could make the same case to extend capital income taxation to gains from the sale of farming, forestry, and mining land: extension will reduce distortions arising from the inconsistent treatment of different types of land.

78. In practice, there are likely to be additional challenges. Gains on land are likely to represent a much more significant part of the value of a business in the land-based sector. There will also be impacts on Māori landowners. There will likely be calls to allow 'rollover relief' for farm-farm swaps (where one farm is sold and another is bought). This reduces the lock-in to individual farms, but means the business owner will be locked into farming more generally, which will discourage diversification. The Secretariat is not aware of any research that quantifies the potential size of these distortions.

79. Further work is necessary to establish the full range of issues and the practicality of including farming, forestry and mining land in a capital taxation regime. Environmental considerations could be important here.

5.4 Depreciable business assets

80. Most non-trading stock business assets are held on capital account. The cost of acquiring them is generally depreciable (with land, buildings, goodwill, and trademarks being non-depreciable on the basis that they are not expected to depreciate in value). A sale of depreciable assets will trigger depreciation recapture (to the extent that the sale price exceeds the depreciated value) or additional depreciation (if the sale price is less than the depreciated value). But the excess of the sale price over the asset's original cost is not taxed, resulting in an asymmetry of tax treatment. Taxing gains on depreciable business assets will correct this distortion.

5.4.1 Economic impacts

81. The Secretariat judges that the economic impact of taxing the gain on sales of depreciable tangible business assets is likely to be small, because these assets do not normally appreciate above their original cost. The tax result is the same as under the current depreciation recapture provisions.

82. Some amortisable intangibles could appreciate in value, such as copyrights and patents. Taxing the gains on these assets will reduce the incentive to create them in New Zealand, but will also reduce the incentive for taxpayers to sell them offshore instead of exploiting them in New Zealand to earn royalties or other income.

5.4.2 Compliance, administration, and integrity impacts

83. Including depreciable business assets in the tax base will have a positive integrity impact. An increasingly important example of this is the treatment of software development costs. There are two problems associated with the non-taxation of gains from sales of software held on capital account:

    - First, there is an incentive to treat software developed for sale as if it has been developed for use, and therefore as a capital rather than a revenue asset. The nature of software makes it difficult to distinguish between sale and use.

    - Second, development costs are often deducted as they are incurred, rather than incorporated into the cost of software and then depreciated. This treatment means there is no depreciation recapture if the software is sold. Tax deductible expenditure is recouped out of proceeds which are tax exempt. Similar issues arise for other forms of depreciable intellectual property (other than patents).

84. Including these assets will create pressure to tax gains on the sale of shares, at least in private companies. Significant tax planning already goes into deciding, when a company is sold, whether the sale should be of the company's assets or shares. A tax liability on sales of appreciated assets, without a tax on sales of appreciated shares, will increase the number of transactions undertaken as sales of shares to avoid tax on the sale of assets.

5.5 Goodwill, trademarks & other non-depreciable intangible property used in business

85. These assets are considered together because they are difficult to distinguish, particularly in the context of the sale of a business. In the case of a business with a strong brand name, for example, it is difficult to split the sale price between goodwill and the value of associated trademarks. Similarly, in e-commerce, it can be difficult to distinguish between the value of goodwill and the value of the software used to run the business or liaise with customers. If gains from the sale of software are taxable and goodwill is not, the vendor is incentivised to attribute as much value as possible to goodwill.

5.5.1 Economic impacts

86. The inclusion of these items in the tax base raises questions about the taxation of what might be seen as the most productive part of the economy. It is difficult to characterise the people making gains from these kinds of sales as speculators. These are the situations where it is often argued that the imposition of tax will be most economically damaging. The extent to which economic damage does occur will depend largely on the treatment of losses. This issue is discussed further in the following chapter.

87. The combined effects of early deductions and no tax on gains (even on realisation) can lead to quite inefficient investment decisions. The following box provides an example of this.

Box 4: A case study on investing in an intangible asset

The combination of early depreciation and the lack of a capital gains tax can lead to inefficient investment decisions. Take the example of Sam – a person on a tax rate of 30%, who can lend at a 5% interest rate, and earn an after-tax interest rate of 5%, by putting her money in the bank.

If Sam invests in an asset whose returns are taxed, the investment will need to generate a 5% risk-adjusted pre-tax rate of return. (For simplicity, we ignore risk, so the pre-tax rate of return is 5%.) After tax, this investment will be as good as putting money in the bank.

If Sam invests in an asset whose return is untaxed, however, the investment will only need to earn 3.5%. An investment bias will have arisen because taxed investments must earn 5% to be attractive on an after-tax basis, whereas untaxed investments only need to earn 3.5%.

Suppose instead that asset returns are taxed, but capital expenditure can be expensed. Sam invests $100 to earn a return of $3.50 per annum. The after-tax cost will be $70 and the after-tax benefit will be $2.45. Sam will earn a 3.5% after-tax return on capital and will be just as well off as if she had put $70 into the bank. The investment is marginal, and expensing provides similar incentives to invest as exempting the yield on an investment.

Suppose that Sam invests in an area where capital can be expensed (e.g. building up intellectual property) and assets can also be sold for capital gain before any income is earned. In this case, an investment which costs $100 and can be sold for $72.45 in a year's time (providing a pre-tax rate of return of -27.55%) will be a breakeven investment. The after-tax cost will be $70.

If Sam had deposited $70 in a bank at a 5% interest rate, she would have ended up with $72.45 after a year. Sam is therefore just as well off as if she had put her money in the bank, despite investing in an asset with a very negative pre-tax rate of return.

5.5.2 Compliance, administration, and integrity impacts

88. The impacts will be similar to those considered above for depreciable business assets.

5.6 Shares

89. There is a strong logic to include gains from shares if gains from business assets have already been included (and vice versa). A failure to do so would create a tax bias in favour of holding assets in companies and either selling the shares (if the assets appreciate) or the assets themselves (if they do not appreciate). A similar issue arises with regard to land: it would otherwise be possible, for example, to sell shares in land-rich companies without paying tax, even though much of the gain might result from an increase in the value of the land owned by the company.

5.6.1 Economic impacts

90. The primary economic issue here is the portfolio distortion that may arise from owners deferring the sale of shares that have increased in value, and, if deductions for capital losses are allowed, accelerating the sale of shares that have decreased in value. The tax system will result in under-diversification if taxpayers defer the realisation of gains to avoid crystallising tax obligations.

91. The other issue is that, in circumstances where capital gains are both expected and unrelated to risk, the absence of a capital gains tax will favour listed equities over other capital assets that are not expected to make capital gains. Expanding the taxation of capital income to include gains on shares will reduce the tax-induced incentive to invest in listed equities, creating a more neutral treatment of capital income at the asset level.

92. It will be necessary in policy design to minimise differences in the treatment of listed and unlisted shares, to ensure there is no tax bias against listed shares. There is also the issue that taxing gains on shares can result in double taxation – to the extent that some of the gains on shares reflect the earning and accumulation of tax-paid profit in the company. This issue is covered more fully later in the paper.

5.6.2 Compliance, administration, and integrity impacts

93. The inclusion of this asset class in the tax base will address many integrity issues – such as the use of dividend-stripping transactions to extract tax-free profits from closely-held companies, and the transfer of asset holding companies to avoid a realisation-based tax on the sale of assets. But it will also create additional complexity if the shares are taxed on a realisation basis, since there will be a need for rules to prevent tax minimisation strategies regarding the timing of gains and losses, as well as rollover relief for some types of corporate reconstructions.

5.7 Broad-based approach

94. The broadest approach, at the other end of the spectrum, is to eliminate the capital/revenue distinction altogether. This means that almost all receipts – whether from sales of assets or services, entry into contracts, or otherwise – will become taxable. Exceptions could be allowed for only a small subset of gains, such as gambling winnings and inheritances.

5.8 Revenue impacts

95. The Secretariat has modelled the impact of taxing capital gains on different asset classes. There are two key assumptions in the modelling: (i) all asset classes appreciate at an annual rate of 3%; and (ii) only gains from the date of introduction are taxed. The actual revenue from a capital gains tax will depend on asset price changes and is expected to be more volatile. The results of the modelling over a ten-year period are as follows:

Table 1: Revenue generated by a capital gains tax

Tax revenue as a % of GDP	Year 1	Year 5	Year 10
All residential land, excluding the family home	0.02	0.21	0.40
Commercial, industrial and other land	0.03	0.23	0.47
Rural land	0.01	0.08	0.13
Depreciable business assets	*Unable to quantify, but modest positive impact expected.*		
Intangible property	*Unable to quantify.*		
Domestic shares	0.05	0.29	0.28
Total	**0.11**	**0.80**	**1.27**

Numbers do not sum due to rounding

96. There are three main caveats to this modelling:

- It does not account for behavioural effects, such as changes in selling behaviour or compliance with the rules.
- It does not account for the revenue already collected from the existing land and share tax rules.
- It does not make an adjustment for land held by tax-exempt entities, such as charities and the Government.

5.9 Conclusion

97. The Group may wish to consider whether there are any viable points to stop along the spectrum of assets. If so, these targeted approaches could be assessed against a broad-based capital gains tax and other forms of taxation (such as RFRM and land taxes in the case of different types of land).

6. First-order design issues

98. This chapter introduces three issues that are central to the design of any regime for taxing capital gains: whether to tax on an accruals or realisation basis; what rate of tax to impose; and whether to ring-fence capital losses.

6.1 Accrual vs. realisation

6.1.1 Accrual-based tax

99. An accrual-based tax taxes the gain in an asset's value over a defined period (usually a year), with the tax payable at the end of the period. The tax liability will arise even if the asset is not disposed of during that period. A decrease in an asset's value is treated as a deductible loss, and offset against other income or carried forward.

100. There are three main advantages associated with an accrual-based tax:

- **Efficiency.** A comprehensive accrual-based tax is, in principle, the most efficient way to tax capital gains because the gains subject to the tax correspond most closely with concepts of economic income.

- **Integrity.** There is limited ability for taxpayers to use timing advantages in the valuation of assets by bringing forward losses or deferring gains. There is no ability for taxpayers to avoid tax by holding assets in companies or trusts where the transfer of ownership via changes in shareholders or beneficiaries is not subject to tax.

- **Ease of administration and compliance.** There is no need to distinguish between revenue and capital costs in an accrual-based tax. Nor is there any need to keep records of prior year transactions until the asset is sold.

101. There are four main disadvantages associated with an accrual-based tax:

- **Valuation challenges.** An accrual-based tax requires a valuation at the end of each period to identify the gain or loss. Valuations are readily available for widely-traded assets, but it is difficult or even impossible to impartially value some types of assets (such as closely-held companies). These valuation challenges will impose much higher compliance costs on the owners of certain types of assets. There are also timing risks associated with valuation. If valuation occurs on a specific date at the end of the taxable period, the owners of seldom-traded shares may be able to manipulate the value of their shares in order to reduce their tax liabilities.

- **Cash flow pressures.** An accrual-based tax will create cash flow pressures for the owners of assets that do not produce regular streams of cash income. Some owners may even have to dispose of their assets to meet the tax liabilities. The risk of forced disposal could discourage investment in assets with upfront expenses but longer-term returns.

- **Volatility of revenue.** Revenue from an accrual-based tax will be closely tied to the value of the capital stock in the economy. If real property and shares are an important source of taxation, then fluctuations in house prices and the share market will affect government revenue flows, and revenue overall will become more variable.

- **Perceptions of unfairness.** An accrual-based tax taxes unrealised gains, which do not necessarily correspond with public perceptions of what constitutes 'income.' It remains to be seen whether taxpayers would consider this a fair approach to taxation.

102. The practical challenges to the implementation of an accrual-based tax are substantial. Consequently, there has been little use of accrual-based taxes in practice.[6]

6.1.2 Realisation-based tax

103. If valuation challenges and cash flow pressures are major drawbacks to an accrual-based tax, the alternative is to tax the gain on assets only when they are sold. Conversely, any losses on the sale of the asset may be offset against other income or carried forward.

104. The key advantages of a realisation-based tax are:

- **Ease of valuation.** After the transition period, there is no need to conduct a valuation because the sale price is used to determine whether there has been a gain or loss.

- **Absence of cash flow pressures.** The owner of the asset can fund the tax liability with the proceeds from the sale of the asset.

- **Social acceptability.** A realisation-based tax is easier to understand than an accrual-based tax, and is already employed in a number of ways within the current system (e.g. the revenue account property provisions).

105. The main disadvantages of a realisation-based tax are:

- **Efficiency.** A tax on realised gains creates an incentive for asset-owners to defer the sale of appreciating assets to avoid crystallising their tax liabilities ('lock-in'), and to bring forward the sale of depreciating assets in order to reduce future tax liabilities. The treatment of losses is a major risk to the efficiency of a realisation-based tax.

- **Volatility of revenue.** A realisation-based tax, like an accrual-based tax, will increase the variability of the revenue base – although the 2009 Tax Working Group concluded that a realisation-based tax has relatively lower revenue volatility than a tax on accrual-basis.

[6] Italy introduced accrual taxation for some elements of capital income in 1998, but the reforms were abandoned after only a few months. In 1984, Canada offered taxpayers the option of being taxed on an accrual basis on publicly-listed shares. Canada provided a number of incentives to encourage taxpayers to take up accrual taxation, including tax on only 50% of the value of the asset, and the ability to offset losses against other income. Take-up of the scheme was low and it was abandoned after one year (Inland Revenue & Treasury 2009).

- **Compliance and administration costs.** There will be occasions when asset-owners are forced to dispose of assets due to circumstances outside their control (such as relationship property transfers or corporate restructurings). There will be other occasions when holding vehicles are used to avoid realisation. The rules needed to deal with these situations will increase the costs of compliance and administration.

6.1.3 Alternative approaches

106. The Secretariat has also identified two alternative approaches that combine elements of realisation- and accrual-based taxes:

- **A hybrid approach.** Assets for which valuation and cash flow are a problem will be taxed on a realisation basis; all other assets will be taxed on an accrual basis.

- **An accrual-equivalent tax** is applied at the point of sale of the asset with an inbuilt interest component to account for the deferral of tax. It deals with the issue of lock-in by imposing a higher amount of tax, as a percentage of the gain, the longer the asset is held. In theory, this will eliminate the deferral advantage of a realisation-basis tax while reducing cash flow pressure on taxpayers – but it will also introduce new distortions in the treatment of different types of assets, and requires knowledge of the distribution of gains across time so the appropriate amount of interest can be charged in each period.

6.2 Rates

107. The tax regime could apply full or reduced income tax rates. Reduced rates are usually justified on the basis of three arguments: that they reduce lock-in; that they reduce the impact of the tax on risk-taking activity; and that they make an allowance for the effect of inflation on the value of assets that have been held for long periods of time.

108. The major problem with reduced rates is that it remains necessary to maintain a capital/revenue boundary between revenue gains (which are taxed at full rates) and capital gains (which are taxed at reduced rates). Reduced rates will also lessen the extent to which the new regime improves the horizontal and vertical equity of the tax system. These effects will reduce the integrity and fairness benefits of introducing the tax.

6.2.1 Stand-alone vs. integrated legislation

109. Some countries also have capital gains taxed as a separate tax at a flat rate which is not integrated with the income tax system. This approach will make the tax less effective in promoting fairness and neutrality. Capital gains will continue to be taxed at different rates from other forms of income. At times it might mean that capital gains are taxed at a higher rate than other forms of income (if, say, capital gains are taxed at a flat rate of 15%, but are received by a taxpayer in tax loss). On the other hand, a separate flat tax could simplify administration and compliance by making it easier for taxes to be withheld on capital gains without any subsequent adjustments.

6.3 Treatment of losses

110. A realisation-based tax creates a strong incentive for taxpayers to bring forward losses and defer gains. Take the example of a taxpayer who owns one asset with an unrealised gain, and one asset with an unrealised loss of equal size. The taxpayer could sell the loss-making asset at the end of the year and offset the loss against other income. Although the two assets have produced no net change in the taxpayer's wealth, the transaction will allow them to reduce their tax obligations.[7]

111. These types of transactions represent substantial revenue and integrity risks. As a result, many countries ring-fence capital losses so they cannot be used to offset other forms of income.[8] But ring-fencing carries with it a different set of risks. In fact, the primary economic risk associated with a realisation-based capital gains tax is that an asymmetry in the treatment of losses and gains will discourage entrepreneurship and risk-taking.

112. Investors choose their investments, and the amounts they are willing to pay, on the basis of the expected return on the investment. Some investments, such as simple debt investments, have fairly certain returns with little risk of variance. Other investments have potential returns that are not well known and can vary greatly (from a realistic possibility of becoming worthless, to some potential of earning very large returns). Entrepreneurship – investing in new ideas, processes and technologies – is an example of the latter type of investment, which can yield large benefits to society as well as the investor.

113. Different investors will have different appetites for risk and reward. Society is best-served if the tax system does not bias their decision-making by skewing expected after-tax returns in favour of less risky investments. A tax system could cause such a bias by *always* taxing a successful investment that earns income, but *not* providing the same level of tax relief for a risky investment that loses money.[9] Balanced against this consideration is the need to protect the tax base from the ability for investors to selectively sell loss-making investments while deferring the sale of investments that have appreciated in value.

114. One way of dealing with this issue is to apply loss ring-fencing to types of investments that are most open to manipulation, and least likely to represent the types of investments that could generate the greatest social gains. This could lead to the following approach:

- Derivatives and sales of portfolio shares (say, holdings of less than 10%) may be most prone to manipulation, and therefore have the strongest need for ring-fencing.

- Land holdings generally do not vary greatly in price changes by parcel, and are less likely to be sold selectively to generate losses. There may be a case to be more relaxed about allowing losses on these.

[7] If the taxpayer sells the gain-making asset and retains the loss-making asset, the opposite outcome will occur. However, since the decision to sell is at least in part in the taxpayer's control, this outcome is less likely.
[8] The Government is currently consulting on a proposal to ring-fence losses from residential investment properties.
[9] This issue is less important for investors holding a portfolio of assets that is subject to ring-fencing: since a portfolio investor is likely to have gains as well as losses across the portfolio, ring-fencing is unlikely to have a significant impact on the investor's portfolio.

- Large company holdings (more than 10%) may represent a substantial stake in the underlying business and be of a nature that should not be discouraged. It may be appropriate to allow realised losses on these also.

115. To prevent the buying and selling of corporate capital losses, the excess capital losses of a company could be subject to a shareholder continuity test (such as the test that currently applies to ordinary company tax losses). Such a test will prevent companies from carrying forward capital losses unless substantially the same shareholders have majority ownership of the company in the period from the start of the capital loss year to the end of the capital gain year. The transfer of capital losses could also be allowed between companies within a tax group (e.g. a consolidated tax group).

116. Loss ring-fencing may not be sufficient to prevent manipulation of the timing of realisation. Specific rules may be necessary to prevent companies disposing of loss-making assets and repurchasing the same or similar assets soon after (i.e. a wash-up sale). Most countries do not recognise capital losses if an identical asset is purchased and sold within a specific time period; instead, the losses are only recognised when the new asset is on-sold. The development of equivalent rules will be a necessary base protection measure.

6.4 Conclusion

117. Decisions on these three design issues will be central to the design of a tax on capital gains. In fact, many of the second-order design issues discussed in Chapter 7 spring from any decision to adopt a realisation-based regime, since there will be a need to decide what constitutes the realisation of an asset, and when it is appropriate to grant rollover relief on realisation. The following chapter works through these issues in greater detail.

7. Second-order design issues

118. This chapter explores a broader range of design issues that will also be important to the effective implementation of a tax on capital gains. This chapter assumes the implementation of a realisation-based tax for the purposes of the analysis.

7.1 Indexation

119. On a first-principles basis, gains on the sale of assets should be indexed for inflation, so that only the real economic gain is taxed. Indexation under a realisation-basis tax will provide a closer approximation of real economic income and reduce the risk of lock-in.

120. The major challenge with indexation relates to complexity of implementation. This is because indexation will need to be calculated on different cost bases if assets are added to or improved over time. Australia's capital gains tax originally included indexation, but it was removed in 1999 because of high compliance and administration costs. The removal of indexation was offset by the introduction of exclusions for some assets, which at least made some allowance for the impact of inflation.

121. Indexation will encourage investment in capital over other forms of income unless it is also applied to expenses and other forms of income. For this reason, the Secretariat would suggest considering indexation in the context of the whole tax system, rather than with respect to a single tax.

7.2 Trusts

122. There is a risk that trusts are used to shelter assets from a realisation-based capital gains tax. Assets can remain in the same trust for eighty years, while the identities of the beneficiaries change over time. Depending on how taxation applies to assets transferred on death, *inter vivos* trusts can be used to avoid tax that would otherwise arise on death.

123. One option for dealing with this problem is to deem periodic disposals of assets held in trusts. The ease of deeming periodic disposals will depend on the types of assets held by trusts: some assets (such as listed shares or real property) will be relatively straightforward to value; others will present greater complexity.

124. Current law treats the transfer of an asset by a trust to a beneficiary as a sale at market value. *Prima facie*, this means that such a transfer would trigger a tax obligation.

7.3 The double taxation of retained earnings

125. A realised capital gains tax could lead to double taxation when a firm has not distributed its income, the retained earnings are reflected in a higher share price, and gains on shares are taxed on sale. From a policy perspective, it would be desirable to prevent such double taxation from occurring.

126. It is unclear how much of a problem this will be in practice. Inland Revenue data shows that public companies distribute most of their imputation credits every year, so they are not accumulating large amounts of undistributed taxed income. But private companies *are* accumulating large amounts of undistributed taxed income, probably because of the additional tax that would be imposed if the income were distributed to shareholders on the 33% income tax rate.

127. The Secretariat has identified several options for dealing with this issue:

- The imputation system could be adapted to relieve double taxation on share sales. One option is to make adjustments to share prices when imputation credit account balances change, or deem imputation credits to be distributed to all shareholders who held shares for some or all of the year, rather than attach imputation credits to specific dividends.

- Another option (which is already available to companies) is to undertake taxable bonus issues. Bonus issues are treated like a distribution of fully imputed cash, with the cash being reinvested in the bonus shares. The reinvestment increases the shareholder's cost base in the company, eliminating the double taxation of retained earnings when shares in the company are sold.

128. Both of these options are likely to be complex, and perhaps even impractical, for widely-held companies. Double taxation may therefore represent an important efficiency cost for widely-held companies.

129. There is little international precedent to draw upon in addressing this issue. Australia, for instance, does not have any rules to address this issue – although this may reflect the fact that the rate of capital gains tax on Australian shares tends to be relatively low.[10]

7.4 Associated persons and corporate groups

130. When tax is imposed on realisation, it is generally necessary to develop rules that defer the recognition of gains and losses on transactions between associated persons. Sometimes this is on the basis that the transaction does not result in a material change in economic ownership of the asset (for example, when an asset is contributed by a shareholder to a wholly-owned subsidiary). Sometimes it is because the transaction has been undertaken to deliberately trigger a loss. New Zealand already has some rules of this kind, but they will need to be reconsidered if a realisation-based capital gains tax is introduced.

131. It will also be necessary to develop rules for transactions within corporate groups. These are, to some extent, a subset of transactions with associated persons. However, there are some further issues that need to be dealt with. For example, in the case of a corporate take-over, there is a strong argument to allow the acquirer to treat the assets of the target as having a cost base equal to the amount paid for the target, rather than the cost base of the assets before the takeover.

[10] The low rate of capital gains tax may reflect the capital gains discount, or the fact that a large percentage of listed shares are held by superannuation funds, which face a capital gains tax rate of 10% on assets held for more than twelve months. Accordingly, there may be less of a need to distribute taxed income to avoid double taxation. On the other hand, imputation credits in Australia are fully refundable to shareholders on a marginal tax rate that is lower than the corporate rate, which would tend to encourage full distribution, at least by listed companies.

132. There will also be a need to decide whether rollover relief should be provided for company reconstructions, mergers and acquisitions. This issue is of particular interest to iwi authorities and entities.

133. A number of countries provide rollover relief when the same or similar assets are purchased. There will be some instances where rollover relief is clearly appropriate – such as when the sale of the asset is outside the control of the asset's owner. (An example of this is when a shareholder is issued new shares after a merger.) However, it is not obvious that rollover relief should be allowed when an asset is sold and replaced with a very similar asset (e.g. a business moving to new premises). Rollover relief can also hinder innovation and generate efficiency costs if it locks firms into replacing sold assets with similar assets.

134. The experience of countries such as Australia is that these rules become very complex and create significant tax planning opportunities. Developing and maintaining these rules will also require significant investment by the Government. It is therefore desirable to keep such rules to a minimum.

7.5 Life events

7.5.1 Relationship property transfers

135. Most countries with capital gains taxes apply rollover relief in the case of a relationship property transfer. This appears to be a reasonable approach, because the transfers are not third-party disposals, but rather a separation of joint assets into the separate assets of individuals.

7.5.2 Death

136. The treatment of disposals on death will be sensitive. One option for dealing with death is to deem a sale at market value on the date of death. A deemed sale will require the estate to value the asset and then pay tax on any resulting gain (or claim a deduction for any loss). The need to fund the tax liability could create cash flow pressure for the estate, particularly in cases where the asset has been held for a long time and the estate does not intend to sell the asset. The Group will need to decide whether this option is consistent with the exclusion of inheritance taxes from the Terms of Reference.

137. Another option is to apply rollover relief when the estate takes over ownership of the asset. For example, the cost base of the asset could be preserved as the asset is owned by the estate and the person who inherits it, preserving the gain. There would then be no need for the estate to fund an immediate tax liability.

138. Current law adopts both approaches for assets that are currently taxed, depending on the type of asset, and the relationship between the deceased and the person receiving the asset. Transfers on death are generally treated as sales at market value, whereas transfers to a spouse or partner generally receive rollover relief, as do transfers of forestry assets to close relatives.

139. The greatest distortions would be created by an approach that did not tax the gain, and allowed the estate or heir to obtain the assets with a new market value cost basis. In that case, the tax would be completely avoided, and there would be an incentive for owners to hold assets until death.

7.5.3 Migration

140. If no tax is imposed when a person migrates – or, more specifically, terminates tax residence in New Zealand – then migration will be a simple way to avoid a realisation-based capital gains tax. In fact, there will be an incentive to migrate for the owners of appreciated assets.

141. One option for dealing with this problem is to deem a disposal upon migration. Deemed disposal could be limited only to those assets that cease to be subject to tax on sale when a person becomes non-resident. (So, for instance, it might not apply to ownership of land in New Zealand.)

142. Deemed disposal will impose compliance costs on the migrant in the year of departure. The migrant may also face cash flow pressures if they retain the asset after migration. Nevertheless, there will be practical challenges with enforcement after the migrant has left the country, so imposing tax on migration will be desirable for integrity reasons.

143. Current law already adopts this approach for migrating companies, and for individuals in relation to financial arrangements and most foreign shares.

7.6 Non-residents

144. Where possible, the rules that currently apply to tax non-residents on their New Zealand-sourced income should also apply to income in the form of capital gains. This will generally mean taxing property located in New Zealand, and not taxing property located elsewhere.

145. There may be a need for some exceptions. New Zealand's tax treaties generally remove the right to tax the residents of treaty countries on assets other than New Zealand land, New Zealand land-rich companies, or assets of a New Zealand branch. This is in return for similar treatment of New Zealand residents by the treaty country. Many countries with broad-based capital gains taxes have similar limitations in their domestic law. The domestic law limitations could go further – for example, even sales of shares in land-rich companies could be exempt if the shareholder and their associates do not hold more than a certain percentage (say, 10%) of the company.

146. The Group will need to consider the desirability of such rules. A practical challenge relates to the enforceability of a tax on sales of shares in land-rich companies, particularly if the company, the buyer, and the seller are all foreign.

7.7 Interactions with international tax rules

147. Taxing gains from the sale of shares in non-resident companies raises a number of issues for consideration.

148. For portfolio (less than 10%) and other non-New Zealand-controlled investment, it will be necessary to consider whether to retain or abandon the current taxing methods (primarily the comparative value, which taxes dividends and accruing capital gains, and the FDR method, which taxes a deemed 5% return each year and nothing else). Abandoning these methods would simplify the tax system, but these methods are in many respects superior to a tax on realised gains, particularly in relation to foreign shares that pay minimal dividends.

149. The taxation of non-portfolio investment in New Zealand-controlled foreign companies (CFCs) raises some different issues. Active income from such investments is not generally taxed until it is distributed to an individual or a trust.[11] This means that:

- If a New Zealand company sells shares in an active CFC, taxing the gain will tax active income when the general policy is not to tax such income.

- To the extent that a New Zealand company derives its value from income earned by an active foreign subsidiary, tax will be imposed at an earlier point than would otherwise be the case when a New Zealand shareholder sells shares in the New Zealand company and pays tax.

150. These issues will need to be taken into account when considering the effect of the tax on New Zealand's international tax settings. One response could be to grant an exemption for any gain or loss arising from a New Zealand company's sale of a non-portfolio interest in an active foreign company. (This would address the first point, but not the second.)

7.8 Transition

151. It is unfair to retrospectively tax gains and losses from assets that were made before the introduction of the tax. There are several approaches for dealing with the transition to the new tax regime:

7.8.1 Grandparenting

152. One option is to limit the application of the tax to assets acquired after the date of introduction. All gains from existing assets will be exempt in the hands of current owners.

153. This approach will avoid the need to value assets on the day the tax is introduced, but it will introduce other challenges. For example, if a property is renovated, at what point do the renovations go far enough that the property ceases to be grandparented? If a company starts to undertake new business, at what point should the shares cease to be grandparented? Complex tracking over time will be necessary to decide whether an asset should continue to be grandparented. Grandparenting will also reduce efficiency by aggravating the lock-in effect for the exempted assets.

154. Grandparenting will reduce the revenue generated by the tax. The effects could be significant: Australia introduced a capital gains tax in 1985 with grandparenting for existing assets, and there are still assets that have not yet been taxed.

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[11] There is an exception if the income could have been earned as easily in a New Zealand company as in the foreign one, in which case it is taxed to the New Zealand shareholder as it is earned by the foreign company.

7.8.2 Valuation day

155. A second option is to tax all assets, but only on the gains and losses accumulated after the date of introduction (the 'valuation day'). On valuation day, each taxpayer will provide a market price for the assets they own. That market price will represent the new cost base against which future gains and losses would be measured.

156. There are strong efficiency and revenue reasons to adopt a valuation day approach, since it will bring all assets into the tax base as soon as possible. On the other hand, a valuation day approach will impose higher compliance costs on existing asset-owners. Some assets, such as shares in private companies, goodwill and other intangible assets, are difficult to value: valuation costs could represent a considerable burden to some taxpayers. This could be dealt with by allowing taxpayers to apportion their actual gains on a pro rata basis between the period before and the period after the introduction of the tax.[12]

157. There are also integrity risks. A valuation day approach will create a strong incentive for taxpayers to inflate the value of their assets in order to reduce future taxable gains, or create deductible losses (particularly if losses are not ring-fenced). The risk of inflated values creating losses could be dealt with by denying a loss for sales of such assets except to the extent that the sale price is below cost.

7.8.3 Hybrid approach

158. In practice, there will probably be a need for a hybrid approach that involves a valuation day for most types of assets, but alternative rules or grandparenting for classes of assets that are particularly hard to value.

7.9 Conclusion

159. These are the main issues to be considered in the design of a tax on capital gains. The Secretariat will support the Subgroup's deliberations on these issues as necessary as design work proceeds over the coming weeks.

[12] Take the example of an asset acquired two years before the date of introduction and sold three years after introduction. If the gain on sale is $1,000, then $400 of the gain would be exempt and $600 would be taxable. The Government considered the use of this method in 1989.

8. Distributional impacts

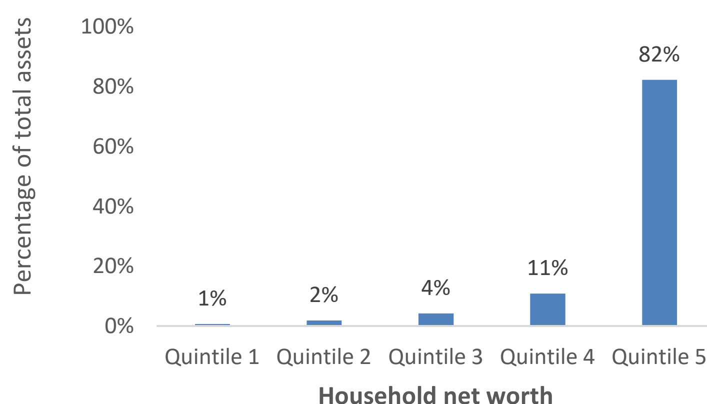
160. This chapter provides a first assessment of the distributional impacts of a broad-based capital gains tax, supplemented by distributional data from Australia and the United States.

8.1 New Zealand data

161. The Secretariat has used data from the Household Economic Survey (HES) to illustrate the distribution of wealth in New Zealand. Estimates using HES are based on sample survey data and are subject to sampling and non-sampling error. Care should be taken when interpreting wealth estimates because the confidence intervals around any point estimates may be wide.[13]

162. The data indicates that the distribution of household wealth is highly skewed. It is even more skewed when owner-occupied housing is excluded (as would be the case for a broad-based capital gains tax that excludes the family home). As illustrated by Figure 2, the top wealth quintile holds about 80% of the assets that would be subject to such a tax.

Figure 2: Household assets (excluding cash, deposits, and owner-occupied housing) by household net worth quintile, 2015[14]



Source: The Treasury, Statistics NZ

163. Figure 3 illustrates that the top income quintile holds about 46% of the assets that would be subject to a capital gains tax that excludes owner-occupied housing. (This income measure excludes capital gains.)

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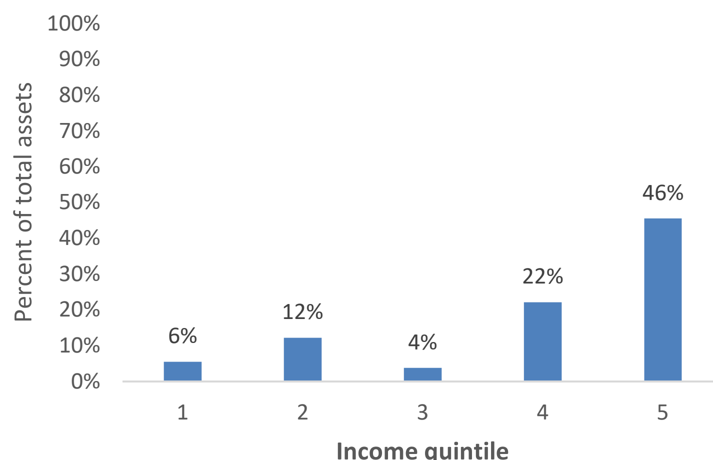
[13] More information about the interpretation of wealth measures estimated from HES is available at http://archive.stats.govt.nz/~/media/Statistics/Browse%20for%20stats/HouseholdNetWorthStatistics/HOTPYeJun15/HouseholdNetWorthStatisticsYeJun15HOTP.pdf. Statistics New Zealand provided access to the HES data under conditions designed to give effect to the security and confidentiality provisions of the Statistics Act 1975.

[14] The measure also excludes non-financial assets other than real estate, e.g. consumer durables.

Figure 3: Household assets (excluding cash, deposits, and owner-occupied housing) by household income quintile, 2015



Source: The Treasury, Statistics NZ

164. However, this data is based on a snapshot of wealth in one year, and does not take account of outcomes over a lifetime. Average wealth rises with age, which is consistent with a life-cycle pattern of saving for retirement.

8.2 Australian and United States data

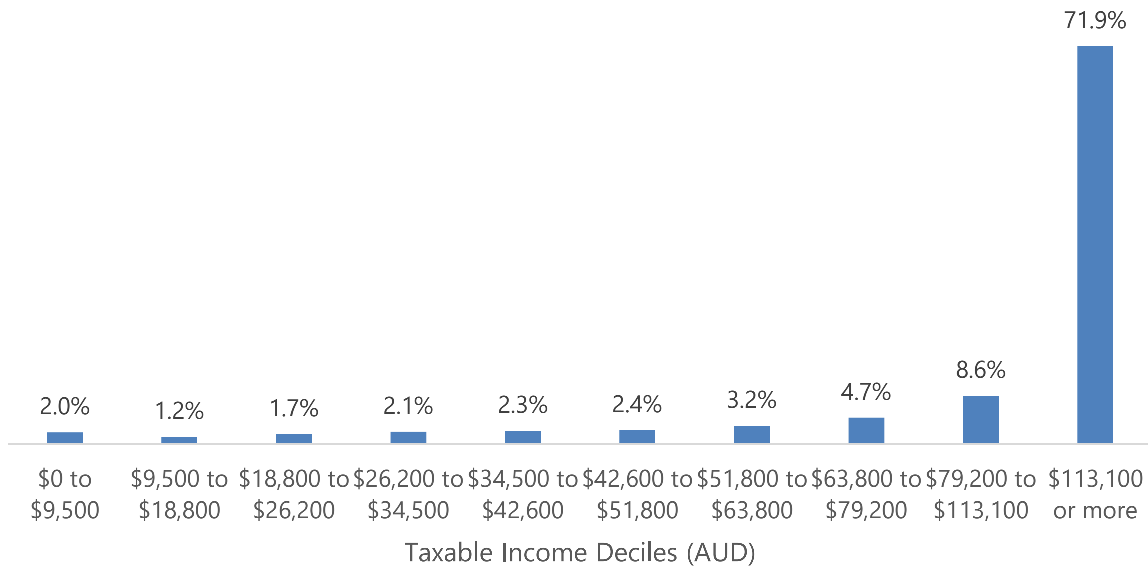
165. The distribution of assets for New Zealand can be compared with the actual distribution of capital gains tax paid in Australia and the United States. Both Australia and the United States have administrative data that show taxable capital gains by income band. The distribution of capital gains tax paid is skewed towards to the top taxable income decile in both Australia and the United States. There is greater concentration in the top decile than indicated for New Zealand in the previous section.

166. This difference will reflect several factors beyond the underlying distribution of wealth:

- Capital realisations will differ from asset holdings.
- The measurement of income is *individual taxable income*, which includes taxable capital gains in Australia and the United States.
- Distributional outcomes will be affected by the specific details of tax design in each jurisdiction.

167. As illustrated by Figure 4, over 70% of capital gains tax in Australia is paid by taxpayers in the top taxable income decile.

Figure 4: Australian income tax returns, 2013/14
Percentage of capital gains by taxable income decile



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Source: ATO data with subsequent calculations by The Treasury

168. Realised capital gains are lumpy over time, so the proportion of capital gains accruing to high income earners may be distorted to some extent by the income measure. In other words, some lower income earners will have relatively high taxable incomes in the year they realise gains.

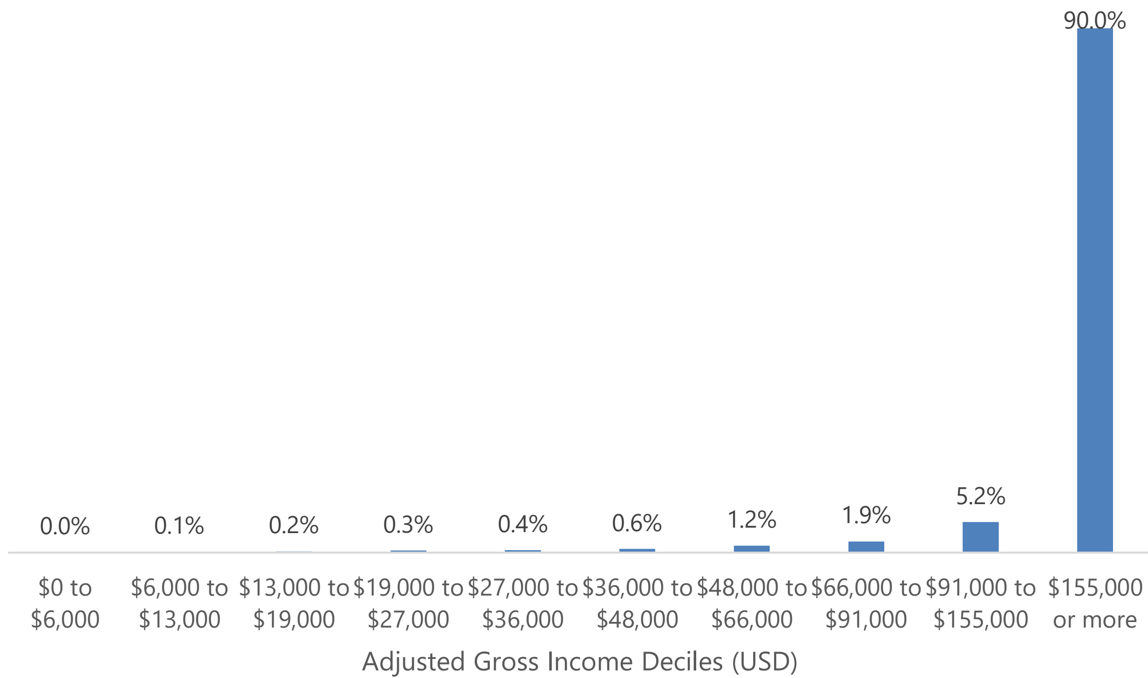
169. The Grattan Institute has examined the distribution of Australia's capital gains by taxable incomes *before* capital gains in order to adjust for this distortion (Daley and Wood 2016). According to this analysis, almost 40% of capital gains are earned by the top 10% of income earners. Another quarter is earned by taxpayers with very low taxable income.

170. The taxpayers with low taxable income tend to come from two groups:

- People over the age of fifty, who have waited until retirement to realise gains, but have much higher lifetime incomes.
- A group of younger Australians, potentially the partners of high-income earners, who are receiving distributions of capital income through structures such as trusts.

171. Figure 5 shows that the results for the United States are even more skewed than Australia, which likely reflects greater inequalities in the American distribution of income.

Figure 5: United States income tax returns, Tax Year 2015
Percentage of capital gains by adjusted gross income decile



Source: IRS data with subsequent calculations by The Treasury

8.3 The incidence of capital gains taxes

172. Capital gains taxes, in all jurisdictions, are primarily paid by the wealthy. Yet this may not reflect the economic incidence of the tax, which will be affected by price adjustments (e.g. to house prices and rents). The Secretariat has commissioned economic modelling to estimate the housing market impacts of capital gains taxation. The results of this modelling will be available by July. The Secretariat also intends to further refine the distributional analysis for subsequent papers to the Group.

9. Compliance and administration impacts

173. This chapter outlines the main compliance and administration impacts arising from a tax on capital gains.

9.1 Stand-alone vs. integrated legislation

174. There are two broad approaches to administration – integration into the Income Tax, or a stand-alone tax. Each approach will have different administrative consequences, depending on the details of policy design, but it is possible to draw some broad reflections. As the McLeod Review noted, there is a risk that the legislation becomes more complex over time as lawmakers attempt to address taxpayer concerns about the fairness and reasonability of the tax. If ongoing changes of this nature are likely, then a stand-alone tax will be simpler and less costly to administer.

9.2 Impacts on taxpayers

175. A capital gains tax will increase record keeping requirements. These will include records of the purchase and disposal of assets kept over a long period of time, records of life events that may change the taxable status of assets, and records providing evidence of the business or personal use of assets. There will be greater interaction between taxpayers and Inland Revenue, with more taxpayers required to provide information and submit returns. Non-business taxpayers will be exposed to a more complex set of tax rules.

9.3 Impacts on Inland Revenue

176. Changes to Inland Revenue systems will be necessary to support the introduction of a capital gains tax. There will also be additional demands on the department. Inland Revenue will need to handle a greater number of returns and offer an expanded advice function to help taxpayers deal with the complex set of rules supporting the new tax.

177. There will need to be an increased audit function arising from having a greater range of taxable activities and associated rules of deduction, as well as expanded debt management activity for defaulters. Depending on policy design, it may be possible to use third parties to provide information to Inland Revenue to reduce compliance and administration costs.

9.4 Impacts on social assistance

178. There will be administrative implications arising from the impact of capital income on the calculation and delivery of social assistance, including the calculation of child support liabilities, student loans eligibility, and entitlement to Working for Families. The definition of income for social assistance purposes also applies to student allowances and other benefits that are not administered by Inland Revenue. Decisions on the definition of income for Working for Families will therefore have broader impacts across the social sector.

10. Interactions with business tax reform

179. This chapter briefly outlines interactions between the taxation of capital gains and other measures for business tax reform.

10.1 Opportunities for reform

180. The taxation of capital gains will provide revenue space for measures that increase the efficiency of the business tax regime. For example, the revenue could be recycled into base changes or rate reductions that improve business investment decisions.

181. An extension of capital income taxation also represents a structural change that would support other business-friendly changes. For example, current restrictions on deducting black-hole expenditure arise from the characterisation of such expenditure as a capital loss; these losses are not deductible because the gains are not taxed. If capital gains are taxed and capital losses deducted, then deductions should also be allowed for black-hole expenditure. (There will still be questions, however, about the most appropriate timing for the deduction, which may depend on the particular type of expenditure.)

182. There is also a case to be more relaxed about allowing depreciation deductions, for example on buildings, if the capital gains will be taxed when the asset is sold.

10.2 Integrity challenges with closely-held companies

183. The Secretariat has previously provided the Group with advice on the integrity challenges that arise from some closely-held company arrangements. Dividend stripping arrangements often generate capital gains as part of a series of transactions; shareholders who wish to extract money from a company without receiving a dividend can sometimes attempt to do so by selling the company to a second company, in which they hold shares.

184. The taxation of capital gains is one among a number of options that could help to address this issue. Once the Group has formed its views on the taxation of capital gains, it will be necessary to consider whether further or alternative measures are needed to address the integrity challenges that arise from some closely-held company arrangements.

185. The Secretariat will provide advice on all of these matters as the Group begins to assemble a package of reform options.

11. Conclusion

11.1 Next Steps

186. This paper has introduced the Group to the main judgements and choices involved in extending the taxation of capital income. The Forward agenda currently includes the following items on extending the taxation of capital income:

Table 2: Forward agenda

Date	Meeting	Item
4 May	Meeting 8	Discussion on taxation of income from capital gains.
1 June	Meeting 10	Report back from Subgroup.
15 June	Meeting 11	Options assessment: land tax / RFRM / capital gains options arising from the Subgroup's work.

187. Subject to any direction from the Group, the next step is for the Subgroup to work up a set of options that could be the subject of more granular assessment. The Secretariat understands that the options for assessment will include a broad-based capital gains tax (excluding the family home) and potentially some more targeted options for expanding the capital/revenue boundary. In the case of land, the options will be compared against RFRM and land taxes.

188. The Subgroup is scheduled to report back on its work on Friday 1 June, and the full set of options will be discussed on Friday 15 June. During this time, more work will be necessary to understand the impact of the options on Māori interests. Public submissions on the submissions background paper and the interim report should also help to clarify the costs and benefits of the various options.

11.2 Issues for discussion

189. The Secretariat suggests that the Group discuss the following issues at the meeting on Friday 4 May:

a. Is the Group comfortable with the approach set out in the Forward Agenda for considering extensions to the taxation of capital income?

b. Does the Group wish to provide any high-level parameters to guide the Subgroup's work on detailed design issues, such as:

   i. The coverage of assets.
   ii. Accrual vs. realisation basis.
   iii. Full vs. reduced rates.
   iv. The treatment of losses.

c. Does the Group wish to rule out any design options before the Subgroup begins its work?

Appendix A: Capital gains and risk-taking

This Appendix responds to a number of issues raised by Subgroup members about the impact of capital gains taxation on risk-taking.

Incentives on risk-taking

Capital gains can arise in a range of circumstances. These circumstances may include: businesses building up intangible assets such as intellectual property or goodwill; investment occurring in longer-term projects that generate little revenue for a period of time; changes in interest rates; or the resolution of uncertainty.

Capital gains will be part of the total return to risky investments, which in turn will generally be expected to earn more than the riskless rate of return to compensate for risk. Subgroup members have asked whether there are grounds to exempt capital gains from taxation on the basis that they reflect, at least in part, compensation for risk-taking.

In the Secretariat's view, the fact that higher returns are demanded of risky assets, and that some of these may accrue as capital gains, does not stand as a reason to exempt capital gains.

Consider an analogous situation: depreciable assets. When depreciable assets are sold there is a depreciation wash up. This reduces risk.

- Assets that have fallen in value more quickly than depreciation schedules allow (and that have been overtaxed) get an adjustment to take account of the full amount they have depreciated when they are sold or scrapped.

- Assets that have fallen in value less quickly than depreciation schedules suggest (and that have been undertaxed) get an adjustment to claw back the excess depreciation they have claimed.

Making a tax adjustment so that those who have done poorly are not overtaxed, and those who have done well are not undertaxed, reduces risk. Similarly, apart from the loss ring-fencing issue (which is discussed below), taxing capital gains and allowing deductions for capital losses would appear to tax income more neutrally and reduce risk.

The impact of loss ring-fencing

Taxes on realised gains often include some form of loss ring-fencing so that capital losses cannot be set off against all income, but solely against income from capital gains. The Secretariat acknowledges that loss ring-fencing can create a bias against risk-taking.

This disadvantage needs to be weighed up when considering the benefits of a general tax on realised gains, as opposed to targeted measures that expand the capital/revenue boundary. The Secretariat would argue that a high bar should be set before deciding to apply loss ring-fencing to a class of assets or investors.

The Secretariat is currently exploring what classes of assets (e.g. land and buildings, or shares in closely-held businesses) could be excluded from ring-fencing to reduce the bias against risk-taking under a broad-based capital gains tax.

Appendix B: The current tax treatment of gains and losses

Table 1: Non-trading stock assets

Type of asset	Tax treatment
Financial arrangements (generally debt and derivatives)	All gains fully taxed, often on an accrual basis. Losses generally fully deductible, except where due to counterparty default, where a statutory version of the capital/revenue distinction generally applies (e.g. retail investors not entitled to a deduction for losses on finance company debentures).
Owner-occupied residential land and buildings	Not taxed.
Other residential land and buildings	If sold within 5 years of purchase, all gains taxable. Losses deductible against other land income. Otherwise, statutory version of capital/revenue distinction applies to determine tax treatment of gains and losses, with some broadening of what is income. Most significant broadening is for land acquired by an associate of a developer, divider, dealer, or builder, if sold within 10 years.
Other land and buildings	Same as for other residential land, except no 5 year rule.
Timber	Gains and losses fully taxable.
New Zealand shares	For non-PIEs, capital/revenue distinction applies to determine treatment of gains and losses. Generally this means no tax, except for share traders and active non-PIE managed funds. PIEs exempt.
Foreign portfolio shares	Generally, tax is imposed each year on deemed income equal to 5% of the opening or average value of the shares for the year. Individuals can pay less if (dividends plus change in value) for their entire foreign share portfolio is a lesser amount. Actual gains and losses are not taxable or deductible.
Foreign non-NZ controlled non-portfolio shares	Generally, the person can choose whether to pay tax on deemed income (as for portfolio shares) or to pay tax as if the shares were in a NZ controlled foreign company.
Foreign NZ controlled non-portfolio shares	Capital/revenue distinction applies, which means gains and losses are generally not taxable or deductible.
Plant and equipment, depreciable intangible property,[15] and certain land improvements[16]	Taxable only by way of a depreciation adjustment, i.e. taxed to the extent that depreciation claimed > actual loss; deduction if depreciation claimed < actual loss. No tax to the extent that sale price > cost.
Other intangible property, including business goodwill	Capital/revenue distinction applies, so gains and losses generally not taxed.
Patents	Gains and losses fully taxed
Other assets	Capital/revenue distinction applies. Generally this means taxable if: • acquired with a dominant purpose of resale; • acquired in the course of a business of which sales of such as assets is an ordinary incident; or • disposed of as part of a profit-making undertaking or scheme.

Note: This table does not take account of special regimes (e.g. mining, films, and bloodstock).

[15] Generally intangible property with a fixed legal life, plus copyright in computer software, sound recordings and plant variety rights, minus patents.
[16] E.g. airport runways, wells, bridges, fences, and roads.

Appendix C: The treatment of gains and losses across countries

This Appendix summarises the tax treatment of gains and losses across OECD countries.[17] The tables in this Appendix are still going through a process of quality assurance.

Real property (Table 1)

Most OECD countries tax gains from the sale of non-corporate real property. It is common for countries to exempt the gain from taxation after real property has been held for a minimum period of time (5-30 years), but only Switzerland has a starting position of not taxing the gain at all.

Few countries adjust the nominal gain for inflation, but several countries offer concessionary treatment after the property had been held for a long time, either through a reduction in the percentage of the gain that is included in income, or through a reduced rate of tax. Canada and Sweden allow for partial inclusion of the gain without needing to meet a holding period.

Sale of shares (Table 2)

Most OECD countries tax individuals on gains from the sale of shares. Several countries exempt the gains after a minimum holding period, ranging from 6 months in Luxembourg to 20 years in Slovenia. Only Chile, Mexico, and New Zealand do not tax the gain at all.

Most countries include the full amount of the gain in an individual's income. Few countries adjust the nominal amount for inflation. Only two counties – Australia and Canada – allow for a partial inclusion of the gain, although Australia requires the shares to be held for a minimum period of a year before partial inclusion.

Treatment of losses (Table 3)

The Secretariat has information on the treatment of losses for a subset of OECD countries only. Among the countries for which data is available, losses are either not allowed to be offset against ordinary income, or are subject to various forms of ring-fencing. Most of the studied countries allow losses to be carried forward, but few allow losses to be carried backward.

Table 3 is based on survey data from a 2006 report and in some cases may be out of date.

The comprehensiveness of capital gains taxes (Table 4)

Most countries operate a comprehensive capital gains tax. However, there are some countries that tax only specific types of real property, and other countries that provide significant exceptions (such as gains from the sale of a business on retirement).

Table 4 is based on survey data from a 2006 study and in some cases may be out of date.

[17] A key to the country codes is available here: https://unstats.un.org/unsd/tradekb/knowledgebase/country-code

Table 1: Real property

	Treatment	Inflation adjustment	Inclusion in income
NZL	NT*	--	After 5 years exempt
AUS	PIT	--	50% after 1 year
AUT	WHT	--	Full
BEL	NT*	--	After 5 years exempt
CAN	PIT	--	Partial: 50%
CHL	PIT	✓	After 1 year exempt for residents
CZE	NT*	--	After 5 years exempt
DEN	PIT	--	Full
EST	PIT	--	Full
FIN	PIT	--	Full. Presumed acquisition cost restricted to 20% of sale price, and to 40% after 10 years
FRA	NT*	--	After 30 years exempt
DEU	WHT	--	Full
GRC	S	✓	Full
HUN	NT*	--	After 15 years exempt
ISL	S	--	Full
IRL	S	--	Full
ISR	S	✓	Full
ITA	NT*	--	After 5 years exempt
JPN	S	--	After 5 years reduced rate
KOR	S	--	After 2 years reduced rate
LUX	PIT	--	Full
MEX	PIT	✓	Full
NLD	PR	--	Full
NOR	PIT	--	Full
POL	NT*	--	After 5 years exempt
PRT	PIT	✓	Partial: 50%
SVK	NT*	--	After 5 years exempt
SVN	NT*	--	After 20 years exempt
ESP	S	--	Full
SWE	PIT	--	Partial: 90%
CHE	NT	--	--
TUR	NT*	✓	After 5 years exempt
GBR	S	--	Full
USA	S*	--	Apportionment system

Key:

NT	No taxation
NT*	No taxation after a holding period
WHT	Final withholding tax
PIT	Personal income tax rate applied
S	Separate taxation of capital gain income
S*	Separate taxation after a holding period
PR	Presumptive return deemed to include capital gain of asset

Sources: Harding (2013), Harding and Marten (2018), OECD (2016), PwC (2017).

Table 2: Sale of shares

	Taxation	Inflation adjustment	Inclusion in income
NZL	NT	--	No taxation
AUS	PIT	--	Full, after 1 year 50% inclusion
AUT	WHT	--	--
BEL	FW/NT*	--	Full, after 6 months exempt
CAN	PIT	--	Partial: 50%
CHL	IM/NT*	--	131.6% (imputation) after 1 year exempt
CZE	NT*	--	Full, after 3 years exempt
DNK	S	--	Full
EST	PIT	--	Full
FIN	PIT	--	Full. Presumed acquisition cost restricted to 20% of sale price, and to 40% after 10 years
FRA	PIT	--	Full, after 8 years reduced rate
DEU	WHT	--	Full
GRC	S	--	Full
HUN	S/NT*	--	Full, after 5 years exempt
ISL	S	--	Full
IRL	S	--	Full
ISR	S	✓	Full
ITA	S	--	Full
JPN	S	--	Full
KOR	NT	--	No taxation
LUX	NT*	--	Full, after 6 months exempt
MEX	S	✓	Full
NLD	PR	--	--
NOR	RRA	--	Full
POL	S	--	Full
PRT	WHT	--	Full
SVK	WHT	--	Full
SVN	S/NT*	--	Full, after 20 years exempt
ESP	S	--	Full
SWE	PIT	--	Full
CHE	NT	--	No taxation
TUR	NT*	✓	Full, after 1 year exempt
GBR	S	--	Full
USA	S*	--	Full, after 1 year reduced rate

Key:

NT	No taxation
NT*	No taxation after a holding period
WHT	Final withholding tax
PIT	Personal income tax rate applied
S	Separate taxation of capital gain income
S*	Separate taxation after a holding period
PR	Presumptive return deemed to include capital gain of asset
RRA	Rate of return allowance

Sources: Harding (2013), Harding and Marten (2018), PKF (2015).

Table 3: Treatment of losses

	Can losses be offset against ordinary income?	Carried forward/backward
NZL	Not taxed.	--
AUS	No.	Forward indefinitely.
CAN	Yes. 50% of losses on shares or qualifying small business.	Forward indefinitely, backward 3 years.
CHE	Not taxed.	--
ESP	Yes. Excess short-term capital losses can be used to offset against 10% of other net income excluding long term capital gains.	Forward 4 years.
GBR	No.	Forward indefinitely.
IRL	No.	Forward indefinitely.
JPN	Yes - only losses from the sale of residential property.	Not on securities/land/buildings; forward on quoted shares to offset gains on quoted shares.
NLD	Yes. 25% of losses on substantial shareholdings may be deducted against tax on employment income.	Forward indefinitely, backward 3 years.
USA	Yes – limited to $US3000.	Forward indefinitely.

Source: Warburton and Henry (2006)

Table 4: The comprehensiveness of capital gains taxes

	Comprehensive?	Exceptions
NZL	x	Only business assets held for resale are taxable.
AUS	✓	
AUT	✓	
BEL	x	Exception for undeveloped land.
CAN	✓	
CHL	✓	
CZE	✓	
DEN	✓	
FIN	✓	
FRA	✓	
DEU	x	Exception for taxpayers aged 55+ or unable to work for liquidation of business.
GRC	x	Only sale of whole business, trade name, trademark, goodwill is taxable.
HUN	✓	
ISL	✓	
IRL	x	Exception for sale of family business after age 55, value cap unless sold to relatives.
ITA	✓	
KOR	x	Only land and buildings are taxable.
LUX	✓	
MEX	✓	
NLD	✓	
NOR	✓	
POL	✓	
PRT	✓	
SVK	✓	
ESP	✓	
SWE	✓	
CHE	x	Movable property taxable, immovable property taxed by some Cantons.
TUR	✓	
GBR	✓	
USA	✓	

Source: OECD (2006)

Appendix D: Secretariat views on design issues

The following table summarises the Secretariat's current views on each of the main design issues for taxing capital gains. The table is intended to help the Group form a view on the preferred features of a system for taxing capital gains, and can be considered when deciding the extent to apply such a regime in extending the taxation of capital income. These views are preliminary and will be refined following further analysis, discussion with the Group, and consideration of submissions.

Design Issue	Secretariat's current view	Comment
Accrual vs. realisation (6.1)	Realisation.	Accrual has some benefits (efficiency, integrity, and no lock-in) but is difficult to apply comprehensively, raises cash-flow issues, and may lack public acceptance.
Rates (6.2)	Potential fairness and efficiency benefits from having gains taxed at full rates as part of income tax. But administration and compliance cost issues require further analysis.	Discounted rates will add complexity, and will not improve horizontal and vertical equity as much as full rates. Many countries tax capital gains at full rates.
Losses (6.3)	Limited ring-fencing (portfolio shares and derivatives only).	Some loss ring-fencing is needed in a realisation-based tax to manage the tax base risk of selective sales of loss-making property. However, ring-fencing should be kept to a minimum since it may distort decisions on investing in risky ventures.
Inflation indexing (7.1)	No inflation indexing (unless comprehensive across the tax system).	Inflation indexing will add complexity, leave capital gains taxed more favourably than other forms of income, and so not achieve horizontal equity. (There may be efficiency and fairness benefits if inflation indexing is done comprehensively across the tax system, but implementation will be complex.)
Trusts (7.2)	Consider measures to prevent indefinite or extended deferral of capital gains realisation.	Trusts could be used as a vehicle to hold property for extended periods without realisation, even while the beneficiaries change. Consider what other countries do and whether there are reasonable countermeasures, such as periodic deemed sales.
Double taxation of retained earnings (7.3)	Consider whether there are any mechanisms to address potential double taxation.	The imputation system prevents double taxation when dividends are paid. It would be desirable to prevent double taxation also in the case of sales of appreciated domestic company shares. There is no international precedent for this, so it may be difficult to address in practice.

Design Issue	Secretariat's current view	Comment
Associated persons (7.4)	Rollover losses on transactions between associated persons.	The rollover of losses for associated party transactions will prevent loss recognition when there is no change in the economic ownership of the asset.
Corporate groups (7.4)	Consider cost-base push-down rules, where the cost of the acquired shares is allocated to the underlying company assets when someone buys a controlling stake in a company.	Push-down rules prevent a disadvantage arising when company shares are bought instead of company assets.
Relationship property transfers (7.5.1)	Apply rollover relief.	It is unfair to tax a relationship property transfer, which is not a sale of the property, but rather a separation of joint property into individual ownership.
Death (7.5.2)	First choice – deemed realisation for market value; second choice – rollover basis to estate and heir.	A tax liability should not be avoided in the case of the death of the owner. A second option is to apply rollover relief and defer the tax until a subsequent sale by the estate or heir.
Migration (7.5.3)	Deemed realisation of assets, subject to a *de minimis* rule.	Migration should not be a method to avoid tax on the sale of appreciated property.
Non-residents (7.6)	Tax sales of appreciated land in New Zealand and the assets of a New Zealand branch only (and land-holding companies).	These sales should be taxed as part of New Zealand's general approach of taxing the New Zealand-sourced income of non-residents.
International tax rules – sale of portfolio shares in foreign companies (7.7)	Consider whether a tax on gains should replace the current FDR rules for income from portfolio shares.	The current FDR treatment has an advantage of taxing income on accrual, so overcoming lock-in. Taxing gains on the sales of foreign shares instead would have the advantage of allowing a consistent rule apply to more categories of investment assets.
International tax rules – sale of shares in controlled foreign companies (CFCs) (7.7)	Exempt gains and losses from the sale of shares in active CFCs from being taxable or deductible. Gains from the sale of shares in passive CFCs should be taxable. Consider the position for CFCs that earn both active and passive income.	We exempt the active income of a CFC from tax on attribution in order to not discourage foreign investment by New Zealand companies. This should not be undone by taxing a gain on sale of CFC shares. Losses should not be allowed as a deduction in order to provide symmetry. Gains on the sale of shares in passive CFCs should be taxable as we generally tax the income from passive CFCs.

Design Issue	Secretariat's current view	Comment
Transition (7.8)	Valuation day.	A valuation day approach will raise revenue faster than grandparenting, and will not cause as many distortions. Deemed valuation options (e.g. pro-rating gains) could be considered for assets that are hard to value. No losses should be allowed (unless an asset is sold below original cost) to prevent windfall gains.

Appendix E: Recent reviews of the taxation of gains and losses

Earlier reviews

In 1987, a Consultative Committee on the accrual tax treatment of income and expenditure expressed a strong preference for a comprehensive CGT, while noting various difficulties in doing so. Also in 1987, the Royal Commission on Social Policy concluded there was an overwhelming argument for a tax on capital gains in terms of both fairness and efficiency. In 1989, the Government released a proposal for the taxation of capital gains that included indexation of the tax base. The proposal was not implemented.

In 1998, a Committee of Experts was established to review aspects of the tax system, including tax compliance and avoidance/evasion issues. The Committee did not express a view on whether New Zealand should tax capital gains, but did point to the complexities associated with both taxing them and not taxing them.

2001 McLeod Tax Review

The Review noted that many capital receipts are taxed, despite the absence of a separate capital gains tax. Two key exceptions were identified: certain shares and real property. The Review acknowledged that, in principle, an accrual-based capital gains tax would be both efficient and fair. But it argued that such a tax is a 'theoretical concept that can never be fully achieved under any real-world income tax.'

The Review also argued that the realised capital gains taxes adopted by other OECD countries add complexity to tax systems, encourage the deferral of gains and acceleration of losses, and create new problems (such as the need to define the point at which an asset is realised, and decide whether to provide rollover relief for the sale and purchase of similar assets).

The Review decided that a realised capital gains tax did not warrant further consideration. Instead, it recommended that the Government pursue a pragmatic approach of taxing capital gains if and when their exclusion from the tax base caused inefficiencies or revenue concerns.

2009 Victoria University of Wellington Tax Working Group

The Group identified a 'major hole in the tax base' regarding the taxation of capital. The Group noted that the tax system's treatment of capital income meant some areas faced zero tax rates, which reduced fairness and integrity, and distorted investment and behaviour. The Group recommended base-broadening to improve efficiency, fairness, and revenue sustainability.

The Group noted that a comprehensive capital gains tax would be the most comprehensive base-broadening option for capital income. Some members of the Group viewed such a tax as a viable option to take forward. Most members, however, were concerned about the practical challenges that would arise from a comprehensive capital gains tax, and the potential distortions that would arise from a partial capital gains tax.

The review noted that an alternative approach to base-broadening would be to identify and target specific areas where income is being systematically under-taxed (such as returns from residential rental properties). A majority of members recommended that the Government consider the use of RFRM to tax returns from residential investment properties.

Glossary

Amortisation. Amortisation is the practice of spreading an intangible asset's cost over its useful life. Amortisation is typically expensed on a straight-line basis, meaning the same amount is expensed in each period over the asset's useful life.

Associated persons. Associated persons are persons or entities with a certain relationship that means they may not always act at arm's length with each other.

Capital account. New Zealand tax shorthand for a gain or loss that is not taxable or deductible because it is considered a capital gain or loss for tax purposes. Also used to describe an asset that when sold would result in a non-taxable, non-deductible capital gain or loss.

Capital income. Earnings from investments and savings, including interest, net rental and business income, capital gains, and dividends.

Controlled foreign company. A foreign company that is controlled by five or fewer New Zealand residents.

Deduction. Losses or outgoings incurred in producing income or running a business that can be used to reduce taxable income.

Depreciation (economic). The decline in the market value of an asset over its life.

Depreciation (tax). The decline in the value of an asset for taxation purposes, which may differ from economic depreciation.

Dividend imputation. A system that integrates the taxation of companies and shareholders by allowing companies to pass imputation credits (representing tax paid at the company level) to shareholders upon payment of a dividend. This allows the shareholder to take into account any company tax paid in respect of a dividend they receive when calculating their tax liability.

Dividend stripping. Dividend stripping is a strategy to reduce the tax burden through corporate distributions that are effectively structured as sales of shares to related persons where there is little or no change in the economic ownership of control of the company.

Double taxation. Double taxation arises when income taxes are paid twice on the same source of earned income.

Economic incidence. The individual or entity which bears the final burden of a tax (or receives the benefit of a transfer), after response effects, such as price and wage changes, are taken into account. This is distinct from the legal incidence of the tax or transfer.

Effective life. The period over which a depreciating asset can be used for income-producing purposes.

Elasticity. A measure of the responsiveness of one variable to changes in another. For example, the ‘price elasticity of demand’ refers to the percentage change in the amount of a good purchased (‘demand’) following a percentage change in its price. If the percentage change in demand is more than the percentage change in price, demand is said to be ‘price elastic’; if it is less, demand is said to be ‘price inelastic.’

Goodwill. Goodwill is an intangible asset that arises when one company purchases another for a premium value. The value of a company’s brand name, solid customer base, good customer relations, good employee relations, and any patents or proprietary technology represent goodwill.

Grandparenting. The preservation of the benefits of previous arrangements for those who qualify, while phasing in new arrangements for the future.

Horizontal equity. Horizontal equity refers to people in similar circumstances being treated in a similar way. For instance, by paying a similar amount of tax in the context of the tax system, or receiving a similar level of benefit in the transfer system.

Intangible assets. Assets that cannot be seen or touched, such as goodwill, patents, software, trademarks, and copyright.

Land rich company. A company where at least 50 per cent of the value of the company is attributable to land, either directly or indirectly.

Legal incidence. The individual or entity legally liable to pay a tax or receive a transfer bears the legal incidence of the tax or transfer. The legal incidence often differs from the economic incidence.

Lock-in. Lock-in describes a situation where is an investor is unwilling or unable to dispose of an asset due to the taxes associated with doing so.

Loss ring-fencing. Loss ring-fencing is a rule that prevents taxpayers from deducting losses from one source of income (e.g. a rental property investment) against another source of income (e.g. wages).

Negative gearing. An asset is negatively geared when its interest payments on borrowings used to finance the asset exceed the income it generates, net of other expenses. Negative gearing commonly refers to the ability to deduct such a loss against another source of income (e.g. wages).

PIEs. A portfolio investment entity (PIE) is a type of entity, such as a managed fund, that invests the contributions from investors in different types of investments. Eligible entities that elect to become a PIE will generally pay tax on investment income based on the prescribed investor rate of their investors, rather than the entity's tax rate.

Revenue account. New Zealand tax shorthand for a gain or loss that is taxable or deductible because it is not considered a capital gain or loss under general (legal) principles, or is explicitly taxable or deductible under the Income Tax Act. Also used to describe an asset that when sold would result in a taxable gain or deductible loss.

Risk-free rate of return method (RFRM). RFRM is a method for calculating and taxing the income generated by an asset. Under RFRM, the total income generated by the asset is calculated by applying a risk-free rate to the equity held by the owner in the asset; the result is then taxed at the taxpayer's marginal rate.

Tangible assets. Assets that can be seen or touched, such as an oven or a building.

Thin capitalisation. An entity is thinly capitalised where it uses a high level of debt, relative to equity, to finance assets.

Trust. A trust exists when a person (the trustee) holds property on behalf of others (the beneficiaries) who are intended to benefit from the property or income of that property.

Vertical equity. Vertical equity is the principle that people with low means should receive greater assistance than those with higher means, and that those with greater economic capacity should have a higher tax burden.

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