Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

This paper contains advice that has been prepared by the Tax Working Group Secretariat for consideration by the Tax Working Group.

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

Appendix I: Changes contingent on a capital gains tax

Further information on specific revenue negative proposals

July 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury

Changes contingent on a capital gains tax

Proposal

1. We have identified two options that should be considered contingent on a capital gains tax being introduced. They are the deductibility of black-hole expenditure and the removal of loss ring-fencing for rental properties.

Black-hole expenditure

2. Black-hole expenditure is business expenditure that is expected to result in an economic cost to a taxpayer, but is neither immediately deductible for tax purposes, nor deductible over time. It is not deductible over time because it does not form part of the cost of depreciable property for tax purposes. It is said to have fallen into a "black hole".

3. Capital expenditure on assets that are not expected to decline in value (for example, land) is not black-hole expenditure, despite the fact that it is not deductible immediately or over time. This is because the taxpayer does not expect to experience an economic loss when it purchases an asset that does not decline in value.

4. While assets that are not expected to decline in value sometimes do, it would only be appropriate to provide deductions for this expenditure if we taxed gains in asset values if they appreciated. If the Tax Working Group recommends a capital gains tax that applies to business assets, in many areas losses will be deductible when they are realised. However, in the context of a capital gains tax that applies to business asset, there is likely to be considerable scope to relax the restrictive position currently in the Income Tax Act with regards to black hole expenditure.

5. There are a number of approaches available. One might be to try to better match the expenditure to its expected life ex ante. Another model might be the Australian approach. In Australia, a particular provision (section 40-880 of the Income Tax Assessment Act 1997), allows a deduction - spread over five years - for capital expenditure not otherwise deductible, but excludes expenditure that forms part of the cost of a depreciating asset or part of the cost of land, amongst other exclusions.

6. The expected cost of such a rule would be not more than $50m per annum.

7. Contingent on a capital gains tax that applies to business assets being recommended by the Tax Working Group, the Secretariat recommends that the Tax Working Group refer in the interim report to the ability and desirability of reforming the treatment of black-hole expenditure to allow it to be deductible over time.

Loss ring-fencing for rental properties

8. Loss ring-fencing proposals that the Government intends to enact will result in losses from rental properties being "ring-fenced" and unable to be deducted against other income. One of the motivations for these rules was the concern that people were reporting tax losses while enjoying economic profits when capital gains were factored into the equation. This motivation is significantly weakened if capital gains will be taxed. In

general it is preferable to have as few ring-fencing rules as possible, as it results in arbitrary non-neutralities based on tax law, rather than economic reality.

9. When fully phased in, loss ring-fencing is expected to raise $190m per year. Removing it would have this same fiscal cost.

10. The Capital Gains Sub-group will give further consideration to this question.