Tax Working Group Public Submissions Information Release

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Submission to the Tax Working Group’s Interim Report

There are serious defects in the Tax Working Group’s (TWG) Interim Report. If implemented, the recommendations

- will exacerbate the already existing mansion effect in housing
- will disadvantage low-income residential renters
- will raise a small amount of revenue relative to current government revenue.
- are unnecessarily complex. These complexities will impose high administration costs on taxpayers and tax collectors, and will invite tax avoidance

The Mansion Effect

I note that the report largely plays this down, most unwisely. The mansion effect already exists and will become worse if the family home is exempt from a capital gains tax (CGT). In my earlier submission, I describe the subdivision in Carterton, in which I live, as dominated by elderly couples and singles living in family-sized houses. To date, their investment choice has been vindicated. Recently the subdivision was extended with larger sections that sold like hot cakes. The houses built thus far are also larger and again are occupied by a disproportionate number of elderly couples. Already, some sections and houses have been resold at good tax-free profits. This overinvestment in housing will only get worse if the family home becomes the sole source of tax-free capital gains.

The TWG report goes someway to recognising the problem by quietly floating a pro rata threshold of $5m. This is absurdly high. The most valuable house in Carterton, which truly is a mansion, sold for $3.05m in 2016. I suggest a threshold that excludes pro rata the top one-third of residential houses by value in every council district.

Problems for Renters

At present, the most tax advantaged house occupiers are the mortgage-free house owners. Those with mortgages indirectly pay tax through the interest paid to the mortgagee. The renters indirectly pay tax through the taxation on the rents they pay to their landlord.

You advise (p.33 sec.27) that ‘housing market impacts are unlikely to be large, but it may be expected that rents will rise over time and house prices will be lower, relative to the status quo…’ (p.36, sec 28) that in the event of increased taxation on rental accommodation, ‘rents should be monitored and should they rise, government should compensate the renters.’ I can see no reason for house prices to fall, especially as the family home will become the final refuge for tax-free capital gains, but rents will rise as surely as night follows day. It is an axiom of economics that price equals cost. Tax is a cost on business. If the government imposes an additional tax on landlords, rents will rise, over time, to the extent of the increased taxation. The TWG solution is for the government to collect the tax from the landlord and hand it to low-income renters as social welfare. This is socially unsatisfactory and administratively expensive. Social welfare should be minimised because it allows some to game the system while others are unjustly denied assistance. Furthermore, many find applying for social welfare humiliating. I do not see any other reason for the inclusion of rental accommodation in the CGT net other than a desire to nail the landlords.

Landlords in NZ have been unjustly demonised. These landlords are more often than not hard-working Kiwis: ordinary people who want to get ahead; people who spend their weekends mowing lawns, repairing and improving the rentals they own. Corporates cannot compete with these home handymen/women landlords which explains the rarity of corporate ownership of residential rentals in NZ. Furthermore, owning a rental has been a productive avenue for hard working Kiwis to get ahead. In recent years, successive governments have instituted measures to clip the wings of these allegedly rapacious landlords. Have the tenants benefitted from these government measures? On the contrary, the result has been a reduced supply of rentals and increased rents.[1]

The CGT as outlined in the preliminary report will exacerbate inequality. The current home owners will become richer as the mansion effect causes further escalation in house prices. The renters will suffer higher rents as extra taxation is collected from landlords. While social welfare payments may lessen the effects of the rent increases, rising house prices will put home ownership further out of reach for low income people.

The Revenue Problem

I am surprised at the modest amount of revenues arising from the comprehensive taxation of capital gains. To persuade the voters to accept a CGT, a political party will need to offer significant off-setting tax cuts. The projected CGT revenue, especially in the initial years, falls well short of that required for significant tax cuts. Table 6.2 (p.41) shows projected revenue of $290m in the first year to rising to $5.9b in the 10th year post implementation. In the context of current government revenue of $75b, the revenue arising from the CGT is hardly compelling, especially as the largest contribution comes from residential rentals. If this impels an equivalent transfer of compensatory payments to the renters, then the capacity to reduce other taxes to offset the CGT revenues will be ever more constrained.

[1] Please note, I do not own a rental, never have and never will.

The Complexity Problem

The complexity of the TWG's interim recommendations is starkly evident in Appendix B: a 43-page explanation of how the CGT might be implemented. Despite the 43 pages, the explanation is incomplete.

There are problems in defining a family (excluded) home, especially if owned by a trust. Why the TWG proposes such lenient and contradictory exemptions for trusts is startling. Usually, trusts are established to avoid taxes, creditors, and/or belligerent spouses. It is in the interests of other taxpayers, creditors and aggrieved spouses that trusts be discouraged. I suspect that the reason behind the acceptance of trust ownership is that John Key spectacularly tripped David Cunliffe on this question in a televised 2014 pre-election debate. Only a home owned by a natural person should qualify as an excluded property. If trustees of house-owning trusts are unhappy about this, they can always transfer the house to the ownership of the beneficiary-occupant.

The limitation of the family home to a single dwelling sounds reasonable until the term family bach/beach house enters the conversation. The family home is excluded from the CGT but not the family bach/beach house. Many see the family bach/beach house as part of the family home. It seems ironic that a mansion far larger and more valuable than a combination of a typical family and bach/beach house should be entirely exempt while the humble family bach/beach house is subject to the CGT.

Then there is the problem of allowing rollovers, that is deferring the CGT in certain circumstances. For example, application of a CGT on the death the asset owner could force a spouse to sell the farm or business, so the option is to carry the CGT forward (rollover) until the next change of ownership. This seems reasonable but what if the spouse is a generation or two younger than the deceased? That would create a large deferment of the tax to the benefit of the asset-owning family.

There is also the suggestion that a farmer who sells a farm to buy another farm should be able to defer the tax until the farmer ceases to own a farm. The same would apply to a business. This seems like a good plan to ease the transfer for a young farmer moving from an entry level farm to an economic unit; the same for an up and coming young business person. But, what is the difference between a farmer selling a farm to buy a better farm and a shareholder selling shares in company A to buy better shares in company B? The farmer can defer the tax, but the shareholder cannot. Why?

The TWG proposes applying CGT to goodwill to include businesses in the taxation net. Most business assets depreciate; land and buildings excepted, but these often comprise a small proportion of business assets. The increase in value of a business in excess of tangible asset value is generally recorded as goodwill. From a taxation perspective goodwill is problematic because it is notoriously malleable. In 2013, the listed company PGW excised all $321m of the goodwill from its balance in one fell swoop. The previous year, the $321m of goodwill had been signed off by the auditors KPMG. Suddenly, the goodwill was zero; it was said that the company was not growing as fast as anticipated. In subsequent years, the company did quite well, but the goodwill was not reinstated.

Goodwill is easy to assess when a business is sold: it is the difference between sale price and the book value of the business assets. But it can be arbitrary when a business is transferred within a family. Should the IRD identify a similar business transaction on the open market, it could be argued that the buyer paid too much. This leads to the problem that it will be relatively easy for a family to minimise CGTs when transferring a business to the next generation, but much harder for farmers, whose main assets of land and livestock are easily valued. I note that when assessing the sources and estimating CGT revenues (pp.41&136), businesses are absent while rural land is prominent. This suggests that CGTs will be collected from businesses in theory only?

The suggested favourable treatment of PIE investment funds is another problem. While I acknowledge that there are difficulties in applying the CGT to PIEs, it would be grossly unfair to private investors if the PIE funds were advantaged. Should this cause private investors to switch to managed funds, the integrity of the sharemarket will suffer from less shareholder scrutiny. What’s worse is that much of the taxation advantage the PIEs might receive will be captured by the fund managers in higher fees. High fund management fees are already a recognised problem within the industry. The difficulties for PIES that the TWG have identified are indicative of the complexities of the CGT that is proposed. Furthermore, it is unacceptable to present an interim report when key issues such as a level field for taxpayers have not been resolved.

Summary

The CGT as outlined is complex, will not raise much revenue but will widen the wealth gap between homeowners and renters.

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