Tax Working Group
Te Awheawhe Tāke

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28 November 2018

Sir Michael Cullen, KNZM
Chair, Tax Working Group

By email: submissions@taxworkinggroup.govt.nz

Dear Sir Michael

Tax Working Group Interim Report – New Zealand tax lawyers' comments

Introduction

1. The New Zealand Law Society's (Law Society) Tax Law Committee is grateful to members Joanne Hodge, Craig Elliffe and Robin Oliver of the Tax Working Group (the Group) for the opportunity to participate in a conference call on 24 October 2018 to discuss aspects of the Group's interim report (the Interim Report).

2. This letter summarises the observations made by individual members of the Tax Law Committee, and other tax lawyers participating in the conference call, in their capacity as senior tax law practitioners, in response to the Interim Report. It should not be taken as expressing the Law Society's concluded view on any matter. This letter is intended to record key issues discussed during that conference call.

3. The references to the chapter numbers, the main headings or paragraph numbers below correspond to those in the Interim Report.

Legislative process, and the GTPP

4. As an initial comment, the Law Society has frequently expressed concerns with the pace of legislative reform, the resultant potential for unintended errors and unintended consequences, the lack of consultation and an inability for key stakeholders to have the opportunity to consider and reflect on proposed law changes, and to make appropriate submissions. If, as seems likely, amendment to the Income Tax Act 2007 to introduce a capital gains tax is to be legislated prior to the next election there will be very little time to observe the Generic Tax Policy Process. There is a material risk that the process will not produce high quality legislation, creating arbitrary and unfair outcomes for taxpayers, and that extensive remedial legislation may be required.

Capital income – Real property and family home exception

5. The proposed exemption for the family home from the taxation of capital gains is an acknowledgement of the societal importance of the family home. For this reason, due to current

house prices in large urban centres, the $5m cap could be considered low. In addition, any cap which is introduced should be indexed to market.

6. Practitioners have suggested that the family home exemption should be replaced by an exemption for "personal land assets". It could be considered unfair for two taxpayers, each with personal land assets worth $5m, to be taxed differently. That will be the case where one taxpayer's entire land assets are represented by the family home and another taxpayer has a lower-value family home and holiday home. Aggregation of personal land portfolio interests would resolve this inequity (along with a cap on the value of the portfolio, particularly the value of the holiday home).

7. A bach is similar to a family home, in that no deduction is available for expenditure on it. This is significantly different to the position in relation to land acquired for investment, which will typically be let out for rental income, and expenditure will consequently be deductible. To that extent, investment property is like any other business. In effect, the rental property is supported by the tax system, and the bach and family home are not. Accordingly, the bach and family home should be treated in a similar way.

8. Therefore, to remove the arbitrary bias against people with baches who have their main home in lower-value areas (and to reduce the bias towards the "mansion effect"), consideration should be given to excluding from a CGT home expenditure which is not deductible by a taxpayer owner.

9. In the absence of a corrective measure for the above phenomenon, a taxpayer who owns a home in a lower-value area and also owns a bach in a lower-value area, will be treated more harshly than a person who owns one home only, in a higher-value area.

Capital income – deemed realisation events for trusts

10. One suggested realisation event, applicable to capital assets held in a trust, is the death of a settlor. However, the trust might (and commonly does) have a number of settlors, or the settlor might have predeceased introduction of the new rules.

11. To this end, a fixed period of ownership for trust-held assets would offer greater certainty and practicality than a link to the settlor's death.

12. This suggestion seeks to align the time at which a trust-held asset is taxed with the time the same assets, when held by a natural person, would be taxed. In the latter case, the person's death is a natural realisation event. Underpinning that is the idea that the "lock in effect" of an asset should not exceed the owner's lifetime.

Capital income – double taxation

13. The Interim Report recognises the potential for double taxation where shares in a company are taxed at the shareholder level. A component of the share price is reflective of accrued gains in the value of assets held by the company. When those assets are later sold, the sale triggers a tax

liability at the company level. Economically, the same income is taxed twice. The Interim Report recognises that the imputation system should avoid that result, but will fail to do so.

14. One way of resolving that would be to operate the imputation system in reverse. A tax liability at the shareholder level could be imposed which would, to the extent it fairly relates to accrued gains in the company's assets, be creditable against those assets.

15. A simpler solution would be to replicate the partnership model, limited to capital assets. Thus, a sale of shares in a company might be treated as a sale of the underlying company held capital assets.

16. Although the Interim Report does not suggest amendments to the imputation regime, we note for completeness that the most effective solution to this issue would almost certainly require reworking or replacing the imputation regime.

Capital income – compliance costs for the "valuation day" approach

17. Part VIII of Appendix B (Design features for extending the taxation of capital gains) of the Interim Report considers the transitional rules that would apply should a capital gains tax be introduced.

18. The Interim Report favours a “valuation day” approach, in that increases and decreases in value of affected assets from the implementation date will be taxed on a realised basis. Paragraph 117 of Appendix B considers a number of rules of thumb that may apply to reduce compliance costs in valuing assets subject to the new capital gains tax as at the “valuation day”.

19. An additional approach that could be considered is to allow taxpayers, at the taxpayer’s election, to allocate realised gains on assets acquired before the “valuation day” based on an index approach. Under this approach, Inland Revenue could publish ‘tables’ that allocate gains from certain asset types (such as residential property, commercial property and shares) given the movement in price indices for assets of that type from the income year in which those assets were acquired to the income year in which those assets were disposed of.

20. This is likely to provide a more accurate allocation of the realised gain than simply pro-rating the actual gain or loss on a temporal basis. These ‘tables’ could be modelled along the lines of the “inflation calculator” available on the Reserve Bank’s website which enables users to apply the CPI, Food, Clothing, Housing, Wages and Transport indices to make price comparisons.

21. In addition, the Group could consider allowing taxpayers the option of:

    a) having their affected assets valued as at the effective date and only the gain brought within the tax net; or

    b) being taxed on the entirety of the sale proceeds, at a reduced rate.

22. If this is not appropriate for all assets, consideration might be given to making the above concessionary option available to businesses, or small businesses, or only in relation to selected

assets. This option would reduce compliance costs in instances where a business is small or difficult to value.

Structure and operation of the proposed taxpayer advocate service

23. Paragraphs 25 to 27 of chapter 17 of the Interim Report recommends that Government establishes a taxpayer advocate service to assist with the resolution of tax disputes.

24. Members of the Tax Law Committee endorse this recommendation. There is a perception among practitioners that the current disputes resolution process in Part 4A of the Tax Administration Act 1994 is not effective for disputes involving individuals, family trusts and small businesses, mainly due to the substantial costs involved and the understandable resulting reticence of taxpayers to take on a government department.

25. Paragraph 26 notes that "The service would need to be functionally independent from Inland Revenue in order to serve as a credible advocate for the taxpayer in dispute". The view of members of the Tax Law Committee is that the taxpayer advocate service would need to be both legally and functionally separate from Inland Revenue in order for taxpayers to have confidence that that the service is truly independent of Inland Revenue. Taxpayers will not have confidence in the service if it is formally part of Inland Revenue (and has access to back-office support from Inland Revenue), even if the agency reports directly to the Minister of Revenue, rather than the Commissioner.

26. The taxpayer advocate service should be completely separate from Inland Revenue and report to the Minister of Justice, as this is an access to justice issue.

Existing disputes regime

27. As noted above, the disputes regime is considered laborious and unworkable for many taxpayers. The time and cost entailed in this process is beyond the means of many smaller taxpayers.

28. The Group could consider improvements to the existing disputes regime. One suggestion is that the conference phase could be more akin to a mediation. The conference phase currently relies on Inland Revenue and the taxpayer reaching a voluntary agreement which, anecdotally, appears to occur in only a very small number of cases.

29. The utility of the conference phase could be improved by empowering the conference facilitator to resolve the dispute. The facilitator's decision, like that of a mediator, would be binding on both parties but with either party having a right of appeal to the Taxation Review Authority or to the High Court where the amount in dispute exceeded a monetary threshold (such as $200,000) or for nominated test cases. The facilitator would need to have appropriate legal and taxation law training, and should not be employed by Inland Revenue.

30. The proposed taxpayer advocacy service should be introduced in complement with the existing (or improved) disputes regime, thereby allowing taxpayers to be ably represented in the conference adjudication.

Company debt and the corporate veil

31. The Interim Report, in chapter 15, paragraphs 70 – 82, suggests the implementation of additional measures to impose company PAYE and GST debts on directors personally. There are already serious sanctions in place for directors who are responsible for failure to pay PAYE.

32. An employer who fails to pay the PAYE to the Commissioner of Inland Revenue by the due date is deemed to have misapplied it.[1] Knowing misapplication of PAYE by the due date is a criminal offence with a maximum penalty of five years' imprisonment.[2]

33. In addition, directors are already responsible for unpaid income tax and GST in circumstances where there has been an arrangement whose purpose and effect is that a company tax liability will not be met.[3]

34. If a further extension of those provisions is considered justified, then consideration should be given to removing the criminal liability on a director who is subject to a Director Penalty Notice.

35. In addition, more consideration should be given to the interface between debt collection and prosecution for outstanding PAYE. In practice, Inland Revenue frequently enters into instalment arrangements for outstanding PAYE, and only prosecutes once matters have become unmanageable. This leads to criminalisation of otherwise law-abiding taxpayers who were led to believe that the issue was a debt collection exercise.

Aligning criminal penalties for GST and PAYE

36. The criminalisation of non-payment of PAYE arises from PAYE being deemed to be held on trust. Consequently, failure to pay it by the due date is a criminal breach of trust, not simply a debt collection issue.

37. By contrast, GST payments are not held in trust for the Crown. This was a deliberate policy decision at the time of implementation of the GST regime. The consequences for taxpayers, tax administration and the effect on the Crown's obligations and immunities for GST refunds owed should be considered if GST debts owed by taxpayers are to be given equivalent status to PAYE debts.

Charities

38. Some legal practitioners have expressed concerns about the Interim Report's general approach to charities. It is their view that the Group must carefully consider the relationship between charities, the tax system and the benefit to New Zealand society as a whole before making any recommendations that would limit or remove tax concessions currently provided to charities.

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[1] Section 4A(2)(c) Tax Administration Act 1994

[2] Section 143A Tax Administration Act 1994

[3] Section HD15 of the Income Tax Act 2007 and section 61 of the Goods and Services Tax Act 1985

39. The Group comments at paragraph 16.4 of the Summary in Chapter 16 of the Interim Report that "the underlying issue is the extent to which charitable entities are accumulating surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities".

40. Some legal practitioners are concerned at the implication of this comment, namely that charities should be limited or prevented from accumulating surpluses. The benefits that charities are currently able to provide to the community could be significantly hampered if charitable entities were compelled to disgorge surpluses. Many long-established charitable entities which function throughout New Zealand, including particularly in the education sector, are able to make a significant impact in the communities in which they are based only by virtue of the fact that they have accumulated considerable capital.

41. Many legal practitioners are of the view that the existing limits on the application of funds other than for charitable purposes are sufficient to prevent misappropriation of tax-exempt income. This concept is not well-understood by members of the public, which may be behind the number of negative submissions the Group has received in relation to charities.

The Goods and Services Tax Act 1985

42. Once the legislative work programme necessitated by the Group's recommendations and the Business Transformation project are complete, many practitioners consider that it would be timely to embark upon a comprehensive review and rewrite of the GST Act. As the Group will be aware, the current legislation is 33 years old and includes extensive amendments. With the recent introduction of the remote services rules, importing of low value goods, and zero-rating of land transactions, as well as several unresolved issues, many practitioners consider that such a rewrite is overdue, especially considering the number of rewrites of the Income Tax Act that have occurred during the same period.

Conclusion

43. We would be happy to discuss any of these matters further if that would assist. I can be contacted via the Law Society’s Law Reform Adviser Emily Sutton [1]

Yours sincerely

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Neil Russ
Convenor, NZLS Tax Law Committee