Tax Working Group
Te Awheawhe Tāke

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Coversheet: Compliance costs of taxing more capital gains

Position Paper for Session 23 of the Tax Working Group
22-23 November 2018

Purpose of discussion

To discuss the increase in compliance costs brought about by taxing more capital gains and whether there are good ways of mitigating these increased costs.

Key points for discussion

- What are the main advantages and disadvantages of Valuation Day compared to Australia's approach of grandparenting pre-CGT assets?
- What are the best ways to reduce valuation costs, both generally and for various types of assets?
- What are the main types of ongoing compliance costs that will be faced by different types of assets and different types of taxpayers? How can these be reduced?
- How do the various design features of the tax such as roll-over, loss ring fencing or small business concessions affect compliance costs?

Recommended actions

We recommend that you:

a **Confirm** the Group's earlier decision to apply a Valuation Day approach as opposed to grandfathering pre-CGT assets.

b **Agree not to** provide a small business concession whereby certain pre-CGT small business assets would be grand-parented (excluded) from the tax.

c To reduce the compliance costs associated with Valuation Day:

   i) **Confirm** the Group's earlier decision to allow the valuation to be determined at the time of the realisation event by using a straight-line apportionment based on the years the asset was owned before and after Valuation Day; and

   ii) **Agree to allow** an estimated market valuation for Valuation Day to be obtained up to five years after Valuation Day.

d **Agree** to focus on reducing compliance costs by making the general tax rules as simple as possible, rather than having further special rules for small businesses.

e **Note** that Professor Chris Evans' report to the Group makes 14 recommendations for reducing compliance costs (see pages 35-37 of his separate report). The Secretariat will report back to you with advice on Professor Evans' recommendations following a planned discussion with the sub-group on Tuesday 20 November.

Compliance costs of taxing more capital gains

Position Paper for Session 23
of the Tax Working Group

November 2018

Prepared by Inland Revenue and Treasury

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EXECUTIVE SUMMARY

1. This paper explores the increase in compliance costs brought about by taxing more capital gains and whether there are good ways of mitigating these increased costs. It focuses on two categories of compliance costs. The first are the one-off compliance costs that arise as a consequence of taking a valuation day approach. The second are ongoing compliance costs.

2. In his report to the Group, Professor Chris Evans notes there have been few studies of the overall compliance costs of capital gains taxes in other countries and these studies are limited to Australia and the UK. Estimates of the overall compliance costs of Australia's capital gains tax suggest it affects relatively few taxpayers each year so has lower annual average compliance costs for businesses compared to other types of taxes. However, the set of taxpayers that interact with Australia's capital gains tax face high costs, and compliance costs are high relative to the revenue raised by the tax. These and other key findings from the relevant studies are further described in Chapter 2.

3. Valuation Day, grandparenting options and ongoing valuation issues are discussed in Chapter 3. Under the tax being considered for New Zealand there will be some additional one-off compliance costs that arise as a consequence of taking a Valuation Day approach. However, there are also significant disadvantages from the alternative approach of used by Australia whereby "pre-CGT" assets were grand-parented so they were excluded from the tax and only came into the tax base when they are sold (or otherwise disposed of, including a deemed disposal) on a day after the capital gains tax was enacted. Note that under either approach, it will still be necessary to implement a full suite of rules and legislation from the date that the tax takes effect.

4. There will also be ongoing valuation issues that arise when certain assets are gifted or purchased from an associated party or when certain assets move into or out of the tax base.

5. Other ongoing compliance costs associated with taxing capital gains more broadly include keeping records of cost basis (including additions to cost basis), determining whether the tax applies, and satisfying new legal tests that form part of the rules.

6. Chapter 4 considers the main types of ongoing compliance costs that may arise for different types of assets and different types of taxpayers. For example, listed shares and real property are relatively easy to value compared to unlisted shares and intangible property. Many small businesses will have few taxable assets (real property and a small amount of goodwill) and will rarely pay the tax. Managed funds will bear the compliance costs on behalf of their investors and custodians and share portals can assist direct investors to comply. It also explains how some of the design features of the tax such as rollover, loss ring-fencing and small business concessions could affect compliance costs.

7. Chapter 5 summarises views from our discussions with Australian practitioners on the compliance costs that occur under Australia's capital gains tax. These views generally support Professor's Evan's empirical findings that while relatively few Australian taxpayers have a capital gain or loss in a particular year, the tax rules are complex and difficult to apply for those that need to apply them.

1. Introduction

1.1 What are compliance costs?

8. As set out in Evans and Tran-Nam (2014)[1], tax compliance costs are the direct costs incurred by taxpayers in complying with the legal requirements of the tax system, excluding the costs of the taxes themselves.

9. Tax compliance costs can be further classified as voluntary and involuntary compliance costs. In the context of taxing capital gains, an example of an involuntary compliance cost would be the requirement to keep records of cost basis. In contrast, a "voluntary" compliance cost would be structuring a transaction in such a way that it is eligible for rollover relief, in circumstances where a different (and sometimes more straightforward) structure would be ineligible for rollover relief.

10. From the Secretariat's perspective, both types of cost are of concern. Both voluntary and involuntary compliance costs are a source of waste in the economy: they use resources without raising aggregate living standards.

11. A decision to tax more capital gains will induce a mix of both voluntary and involuntary compliance costs. While the design of the tax should be carried out in a way that attempts to minimise both, it is clear that there will be additional voluntary and involuntary compliance costs.

12. This paper explains how compliance costs differ for different types of assets or taxpayers. Ahead of the ultimate decision of whether to recommend such a tax, the voluntary and involuntary compliance costs should be thought of as a net cost to the economy that contributes to the downsides of the tax.

[1] Tax Compliance Costs in New Zealand: An International Comparative Evaluation (2014)

2. Professor Chris Evans' work on compliance costs

13. The Group commissioned Professor Chris Evans to provide a report on the compliance costs of taxing more capital gains (see his separate report *The Compliance Costs of Taxing Capital Gains*).

14. Professor Evans' report notes that there have been few studies of compliance costs of capital gains taxes in other countries. These studies are limited to Australia and the UK and are mostly older studies. Some key findings from Evans' review of the relevant studies are summarised below.

2.1 Findings from Studies of CGT compliance costs in other countries

CGT may have high implementation costs relating to record-keeping and valuation

15. In his report to the Group, Evans reviews three older surveys of UK practitioners (from 1969-70, 1983-84 and 1992) and summarises them as follows:

> *"Summing up the UK literature on the compliance costs of taxing capital gains, it is fair to say that it is largely historical, somewhat limited… primarily but not exclusively qualitative and practitioner focused. It suggests that CGT compliance costs are likely to be relatively high, particularly at the outset, as a result of the complexity of the tax itself, and that the burden will be regressive, even though it only affects a relatively small proportion of the taxpaying population. And finally, it identifies specific areas of the tax (record keeping and valuation) that are likely to lead to relatively higher compliance costs than other CGT areas.*

16. Evans also observes that "*compliance costs become less onerous over time as taxpayers become more familiar with their operation, and this certainly appears to be the case with the CGT in the UK."*

Aggregate CGT compliance costs are low compared to other taxes (as CGT is paid rarely by most taxpayers)

17. Evans co-authored a 1997 study of tax compliance costs for the Australian Government.[2] As documented in his paper to the Group, the 1997 study estimated that:

> *"the compliance costs faced by all taxpayers that related to CGT in the 1994-95 year of income were AU$155 million or only 3.3 per cent of all Federal tax compliance costs… By way of comparison, income tax (excluding CGT) accounted for about 42 per cent of taxpayer compliance costs, PAYE 15 per cent, Wholesale Sales Tax 11 per cent, the Prescribed Payments System 10 per cent and Fringe Benefits Tax 6 per cent."*

[2] C Evans, K Ritchie, B Tran-Nam and M Walpole (1997), A Report into Taxpayer Costs of Compliance, Canberra: Australian Government Publishing Service.

However, CGT compliance costs are high as a percent of revenue collected from the tax

The same 1997 study found that CGT compliance costs represented 16 per cent of CGT revenue (AU$994 million in 1994-1995). This is high compared to the 7 per cent figure that was estimated for all taxes relative to total tax revenue. Evans observes in his report to the Group that this finding *"implied that CGT was a relatively expensive tax in terms of compliance for those taxpayers affected by it."*

For both small and large businesses the compliance costs from other taxes are much bigger than CGT. This is because most businesses rarely pay the CGT.

Evans' report to the Group also cites two studies he co-authored in 2014 and 2016 that surveyed the tax compliance costs for small and large businesses in Australia. Both studies found that CGT was a very small source of tax compliance costs compared to other types of taxes.

Average hours spent per year by businesses on tax compliance				
Size of business by turnover	**CGT**	Income tax (excluding CGT)	GST	All taxes
Up to AU$75,000	**0.4**	15.8	15.7	37.5
AU$75,000 to $2 million	**2.6**	35	66.6	143.6
AU$2 million to $50 million	**12.4**	55.4	148.5	482.2
Average for all businesses up to $50 million of sales	**4**	33	69	185

Source: P Lignier, C Evans and B Tran-Nam (2014), "Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector", Australian Tax Forum, Vol 29 No 2, pp 217-247.

Large corporations' total tax compliance costs (percent of total)				
Type of cost for large corporation	**CGT**	Income tax (excluding CGT)	GST	FBT
External tax advisor costs (% of total cost)	**2.1%**	66.4%	9%	5.3%
Internal staff time spent on tax activities (% of total time)	**2.6%**	52.9%	15.9%	11.7%

Source: C Evans, P Lignier and B Tran-Nam (2016), "The Tax Compliance Costs of Large Corporations: An Empirical Enquiry and Comparative Analysis", Canadian Tax Journal Vol 64, No 4, pp. 751-793, at pp 778-779

3. Valuation Day and valuation compliance costs

18. There are two main options for transitioning existing capital assets into a capital gains tax:

- A Valuation Day approach whereby all existing assets are valued on a particular day and any gains in value from that day are taxed when they are realised (e.g the assets are sold). This method was employed in most countries, including Canada and South Africa.

- Australia's approach whereby "pre-CGT" assets are grand-parented so they are excluded from the tax and only come into the tax base if and when they are sold (or otherwise disposed of, including a deemed disposal) on a day after the capital gains tax was enacted.

19. This chapter summarises the main advantages and disadvantages of these two approaches.

20. It then discusses a number of options for reducing the compliance costs associated with obtaining valuations for Valuation Day. Finally, it considers the compliance costs that may arise in other cases where a market valuation may be required such as a sale to an associated person.

3.1 Compliance costs of Valuation Day

21. The compliance costs associated with obtaining valuations for Valuation Day differ markedly depending on the type of asset.

22. For listed shares the market share price can be easily obtained. To further simplify this, Inland Revenue could publish the relevant share prices for NZX and ASX-listed shares (most other listed shares will already be subject to the FIF / FDR rules, rather than the tax on capital gains).

23. For land and buildings there are already well-established valuation practices that are used by professional valuers for determining property values and ratings values. However, professional on-site valuations can be expensive. In the earlier Valuation Day report two lower cost options were identified to reduce the costs associated with valuing real property:

    - Comparable properties – this could be done manually by identifying comparable properties in a sales database or it can be automated using software services which are already commonly available (such as QV's automated valuations). These automated valuation tools offer an immediate, simple and inexpensive valuation option for all residential property owners. Automated valuations are fairly accurate relative to actual sale prices.[3] QV also offers a low cost "desk-based" valuation

[3] The QV automated valuation software is tested every week against property sales from the last six months. The results show that nationally it consistently values properties within 10% of the actual selling price

service for valuing rural land based on comparable properties.[4] Such farm valuations are currently used to apply other tax rules such as GST apportionment and Inland Revenue's Interpretation Statement on the deductibility of farmhouse expenses. Another valuation software provider, CoreLogic maintains a detailed database of commercial properties in Auckland, Wellington and Christchurch which could be used to identify comparable commercial properties in order to inform a valuation.

- Ratings valuation (RV) – these is easily obtainable but may be inaccurate depending on when it was last updated (they are updated every three years at differing intervals for each local authority). A choice between the RV before and after Valuation Day may be more accurate in some cases.

24. As noted in the earlier Secretariat paper on Valuation Day, these options could be tailored to err on the side of generosity to reduce the incentive for asset owners to 'value-shop' using both professional valuers and any default rules.

25. In saying this, the Secretariat accepts it can be difficult to value unlisted businesses and intangible business assets such as goodwill and IP. The value of such assets is very fact-specific to each business and the resulting valuations can be very subjective.

3.2 Valuation Day vs. grandparenting of pre-CGT assets

26. Australia's approach of grandparenting pre-CGT assets has two main advantages over a Valuation Day approach.

27. Firstly, it reduces the compliance costs associated with having to establish valuations for all existing assets. However, a lot of assets such as listed shares and real property are relatively easy to value so it doesn't make sense to exclude them from the tax on valuation grounds.

28. However, if the grandparenting rules only applied to assets that are difficult to value such as closely-held companies and intangibles this would reduce horizontal equity and could create investment biases. For example, it would make it much more attractive to own shares in closely-held companies as opposed to listed shares or managed funds. It would also create boundary issues and related integrity concerns. For example, because the shares of a closely held company could be sold without being taxed on gains the rules would be need to prevent real property or listed shares from being shifted into closely-held company.

29. The second advantage of grandparenting pre-CGT assets is that assets generally enter the regime as the result of an actual arm's length sale and this means the resulting cost base

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over 69% of the time, and within 20% of the selling price for over 93% of properties. Internationally, being within 10% of the actual selling price 65% of the time is considered to be very good. https://www.qv.co.nz/valuations-and-reports/the-evaluer

[4] Quotable Values rural value service.

should be accurate and less likely to be disputed by the tax authority. As there will be fewer subjective valuations this may reduce the number of disputes in the first years of the tax.

30. However, pre-CGT assets may become post-CGT assets in ways other than by an arm's length sale. Australia has continuity provisions whereby a pre-CGT asset loses its status because there has been a significant change in the nature of the asset or its ownership. This applies when either 50% of a company's shareholders change or more than 75% of the company's assets (excluding trading stock) become post-CGT assets. Such rules are important because otherwise, taxpayers could put a pre-CGT asset into a shell company and sell the shares in the company, while keeping the asset's pre-CGT status. The practitioners we spoke to noted that these continuity rules were complex to track and apply. In addition, any capital improvement on pre-1985 land is treated as a new separate asset.

31. Australia's experience is that there are still significant disputes involving valuation issues. One Australian practitioner we spoke to estimated that 40% to 50% of the capital gains tax disputes they had been involved in were valuation disputes. Other Australian practitioners confirmed that such disputes could be costly and difficult.

32. These disputes reflect the fact that a subjective valuation is still required for any disposal (or deemed disposal) that does not involve an arm's length sale to an independent party (and that doesn't qualify for rollover). This includes a sale to an associated person, a gift or because the asset ceased to qualify as a pre-CGT asset.

33. The Secretariat therefore considers that the advantages of grandparenting pre-CGT assets are relatively limited and would mainly help mitigate valuation costs on hard to value assets such as unlisted businesses and intangible assets.

34. We also note that grandparenting pre-CGT assets would not address concerns about the limited timeframe for developing the detailed design of the rules. This is because it will still be necessary to implement a full suite of rules and legislation from the date that the tax takes effect.

35. Compared to a Valuation Day approach, grandparenting pre-CGT assets would be less fair, less efficient and add compliance costs in the longer term from having to track whether assets have retained or lost their pre-CGT status. It would also greatly reduce the revenue that would be collected in the first years of the tax (we have been unable to forecast this revenue difference in the time available but can report back on this if necessary). The advantages and disadvantages are summarised in the following table.

Grandparenting all pre-CGT assets	
Advantages	***Disadvantages***
• Removes valuation day compliance costs for existing assets. • As there will be fewer subjective valuations it may reduce disputes in the first years of the tax.	• Reduces fairness as existing asset owners are not taxed on their gains. In contrast anyone who buy assets after the date of introduction will be. • Reduces fairness as wealthier people are likely to be able to retain their pre-CGT

	assets for longer and therefore get a longer period of untaxed gains. • Reduces efficiency as there is a strong "lock in" incentive to retain pre-CGT assets as gains on these assets will never be taxed (rather than sell them or replace them with different assets). • It will still be necessary to implement a full suite of rules and legislation from the date that the tax takes effect. • Need to track changes to assets and shareholdings to determine if pre-CGT assets change into taxable assets (in which case valuation compliance costs will still be incurred). • Creates apportionment issues as some assets will be a mix of pre-CGT and post-CGT assets such as land with a new building on it. • Will greatly reduce the revenue that will be collected in the first years of the tax.

Views from Australian Practitioners

36. The three Australian practitioners we spoke to had mixed views on Australia's experience with grandparenting pre-CGT assets. Two practitioners considered it was a sensible approach to bringing in the tax with few long-term consequences, while one considered it was a mistake and had led to increased cost and legislative complexity.

37. Professor Chris Evans was very critical of Australia's approach. In his report to the Group he noted that up to 20 per cent of the volume of Australia's capital gains legislation was rules to deal with pre-CGT assets and that pre-CGT grandfathering was "arguably the single largest determinant of tax system complexity in Australia."

38. Practitioners 1 and 2 noted that in their experience they were now dealing with very few pre-CGT assets – they hadn't seen any in the last 10 years. Practitioner 1 said that some high wealth individuals may still have pre-CGT assets.

39. Practitioner 3 considered there were still many pre-CGT assets around as there were strong "lock-in" incentives to not sell such assets to ensure they continued to be excluded from the CGT regime. They also noted that some taxpayers used elaborate tax planning to keep the pre-CGT status of their assets.

40. In contrast, practitioner 1 noted they were not worried about "lock-in" as most assets were sold relatively regularly.

41. It was noted that Australia implemented "close-out" rules to bring all managed fund assets into the tax base in 1989 and all listed company assets into the tax base in 1998. This approach to providing a transition period before bringing in the remaining unsold assets was viewed positively by practitioners.

42. A summary of comments made by the Australian practitioners on other topics relevant to compliance costs is provided in chapter 5.

Secretariat recommendation

43. The Secretariat recommends that the Group confirm its earlier decision to apply a Valuation Day approach as opposed to grandfathering pre-CGT assets.

3.3 Grandparenting pre-CGT assets for small businesses only

44. One alternative option the Secretariat has considered is a hybrid approach whereby the pre-CGT asset approach would be provided as a concession for assets owned by a small business and the Valuation Day approach would apply to all other assets.

45. This could mitigate some of the compliance costs associated with valuing a small business, and particularly the value of goodwill in a small business. It could be targeted at hard to value assets where the compliance costs are likely to high in the context of small amounts of capital gains on these assets.

46. However, this hybrid approach has its own problems.

47. A concession for small business assets would reduce fairness and the revenue that is collected from the tax as existing small businesses would not be taxed on any gains made on their existing assets. In contrast other asset owners including bigger or new businesses would still be taxed on any of their gains made since Valuation Day.

48. Other difficulties relate to the design of the concession. If it applied to all small business assets there would be an incentive to shift assets such as real property and listed shares into a small business prior to Valuation Day in order to exclude these assets from the tax.

49. To combat this it would be necessary to limit the concession to certain assets such as intangible assets (on the basis that these are hard to value) or to active business assets such as business premises and intangible assets which are used by the business.

50. However, this means that the small business concession would be difficult to apply in those cases where a company owns a mix of excluded and taxable assets (such as land rented to another person or assets the business purchased after Valuation Day) and sells some or all of its shares. This is because a portion of the gains on these shares should be taxed as these gains may relate to an increase in value of the underlying taxable assets.

51. The concession would also require a definition of an eligible small business. The experience in Australia suggests small business eligibility criteria can in themselves be a significant source of complexity and compliance costs. However, we consider a much simpler definition of small business can be developed for the purpose of this rule and other small business measures. Some potential definitions for the qualifying small businesses, and other design details for this option are discussed in the appendix. The appendix illustrates some of the complexity of designing this concession.

52. The advantages and disadvantages of grandparenting pre-CGT assets for small businesses only are summarised in the following table.

Grandparenting pre-CGT assets for small businesses only	
Advantages	***Disadvantages***
• Reduces valuation day compliance costs for qualifying small businesses (but only to the extent that their assets qualify for the exclusion).	• Many small businesses will own a mix of excluded and taxable assets (such as land rented to another person or assets purchased after valuation day) so will still have to determine (and apportion) asset values. • Reduces fairness (horizontal equity) as existing small businesses would not be taxed on their gains while other asset owners including bigger or new businesses would be. • Requires a definition of a small business and applying this definition could be complex and involve compliance costs. • Compliance costs from tracking changes to assets and shareholdings to determine if pre-reform assets change into taxable assets (in which case valuation compliance costs will still be incurred). • Reduces the revenue that will be collected by the tax (although the capital gains on existing small business assets will be a very small fraction of the total revenue collected under the tax).

Secretariat recommendation

53. The Secretariat does **not** recommend providing a small business concession whereby certain pre-CGT small business assets would be grand-parented (excluded) from the tax.

3.4 Other options for reducing valuation day compliance costs

54. The Secretariat has considered a number of other options that would reduce compliance costs associated with valuing assets on Valuation Day. These options are based on Valuation Day measures that were used in South Africa and Canada.

55. In the New Zealand these measures could be restricted to those assets which are difficult to value such as unlisted businesses and intangible assets. As discussed earlier it should be relatively easy to establish accurate market valuations for listed shares and real property so allowing less accurate valuation methods to be used for these assets could encourage taxpayers to employ multiple methods to identify which produced the most favourable tax outcomes – this would reduce revenue integrity and increase gaming and increase complexity and compliance costs.

56. Unlike the grandparenting of pre-CGT assets, these options are not concessionary as they do not remove tax liabilities. Instead they provide simple ways of obtaining valuations that remove the need to obtain a market valuation on Valuation Day. Under these approaches, the choice to obtain a market value for Valuation Day would still be available for asset owners that considered that was a better option.

57. In addition to the options considered below, the Secretariat notes that it will continue to investigate whether there are other online calculator-type options that could be developed before any Valuation day, which would use variables considered by valuers to provide an estimated value for a small business. This would require consultation with the valuation industry.

3.5 Straight line apportionment

58. When considering the earlier *Valuation Day* report, one option which the Group agreed would be available to taxpayers was straight-line apportionment. Under a straight-line apportionment approach, at the time the relevant asset is sold, the owner would determine the total gain on sale derived over the whole period of ownership, and then determine what proportion of that gain was derived after Valuation Day. This valuation method was available in South Africa and in the UK.[5] To further reduce compliance costs, the South African Revenue Service provides the calculator on its website.

Example – straight-line apportionment

John purchased a small trucking business on 1 April 2015 for $200,000. On 31 March 2025 (ie, 10 years later), John sells the business to Paul for $600,000. Assume there has been no capital expenditure.

[5] It was available when the UK introduced their 1965 capital gains tax, but was not available in 1989 when the UK "re-based" assets (that had not been sold since 1985) to their 1985 values.

John is taxed on the capital gain he has derived since Valuation Day (1 April 2021) from the sale of the business (ie, for the last 4 years he owned the business).

Applying a straight-line approach, John will pay tax on 4/10th of the gain on sale.
The total gain is $600,000 - $200,000 = $400,000. 4/10ths of $400,000 is $160,000.

59. This option could also be used in conjunction with a Valuation Day approach whereby a business may obtain market valuations for its tangible assets on Valuation Day, but does not value its intangible assets. This is illustrated by the following example.

Example – mix of valuation day and straight-line apportionment

5 years before valuation day A Co started business and by valuation day has tangible assets with a cost and a valuation of $1,000,000. 5 years after valuation day the value of its tangible assets has increased to $1,800,000 and the owners of A Co sell to new owners for $2,000,000. The remaining $200,000 is attributed to goodwill. As A Co has been in business for 10 years and subject to the extended taxation of capital gains for only 5 years it is taxable on $200,000 x 5/10 = $100,000.

The original owners of A Co have a gain of $800,000 for tangible assets and $100,000 for goodwill for a total taxable gain of $900,000.

60. One potential complication is where a business using this method sells an intangible asset that was owned before valuation day as this will not have been valued so will not have a cost base. As with the business as a whole the taxable portion could be determined by subtracting any identifiable costs then apportioning the remaining amount over the proportion of time the extended taxation of capital gains applied.

61. The advantages and disadvantages of straight line apportionment for unlisted businesses are summarised in the following table.

Straight-line apportionment	
Advantages	***Disadvantages***
• Removes valuation day compliance costs • Relatively simple • Takes into account the time that the assets were owned pre and post valuation day. This will be more accurate than a fixed percentage of net proceeds (see option below)	• Fairly crude – likely to overtax or undertax compared to actual gain since valuation day. • Slightly more complicated calculations when a business with a mix of valued and unvalued assets is sold. • The value is likely to be inaccurate where assets have not grown at a

• Can provide a calculator on IRD's website to further simplify the calculation	consistent rate before and after the Valuation day. • May be difficult to apply to assets whose cost base includes a number of items of expenditure spread over a number of years, or where taxpayers are unlikely to have kept a track of the cost base.

3.6 Fixed percentage of net proceeds (Not recommended)

62. In addition to a straight-line apportionment South Africa allowed assets to be valued at 20% of net proceeds after deducting allowable expenditure incurred on or after valuation day. Although this approach is simple to calculate it is arbitrary and will provide a less accurate valuation than straight-line apportionment so it is not recommended. As illustrated in the example below it will often overtax the gain (unless a high percentage was used).

> ***Example – 20% of net proceeds***
> Assume the same facts as in the example above. Applying a 20% of net proceeds approach John will pay tax on 80% of $600,000 which is $480,000.

Percentage of proceeds after deducting post valuation day costs	
Advantages	***Disadvantages***
• Simple to calculate. • Removes valuation day compliance costs.	• Very crude – likely to overtax compared to actual gain (unless a high percentage was used). • Unclear what percentage is reasonable. South Africa used 20 percent which assumes 80 percent of the net proceeds are a capital gain that accrued after Valuation Day.

3.7 Allow the Valuation Day estimated value to be obtained after Valuation Day

63. Canada did not provide any time limit for obtaining a Valuation Day estimated value. This means the estimate could be prepared at any time up until a realisation event. This has the advantage of delaying valuation costs (or potentially removing them for assets which never experience a realisation event). However, if many years have passed between valuation day and the date of valuation it may become harder to determine the value at valuation day (as the asset may have changed or the relevant data on comparable assets may become more

difficult to obtain). Indeed, the Canadian guidance noted "if you wait, the value becomes increasingly difficult to establish."[6]

64. South Africa allowed three years from the start of their rules to obtain a Valuation Day value.[7]

65. The Secretariat suggests a five-year deadline for obtaining estimated market valuation for Valuation Day could be an appropriate trade-off between allowing taxpayers adequate time to arrange a suitable valuation but not waiting so long that it becomes too difficult to determine the past value of an asset. So, if Valuation Day was 1 April 2021, taxpayers would have until 30 March 2026 to estimate and record what the value of their assets was on 1 April 2021. However, if any of their assets were subject a realisation event between 1 April 2021 and 30 March 2026 they would have already needed to determine the value of the asset on 1 April 2021 in order to calculate the relevant capital gain or loss.

Allow the estimated market valuation for Valuation Day to be obtained up to five years after Valuation Day	
Advantages	***Disadvantages***
• Spreads the workload for valuers and taxpayers as they can prioritise obtaining valuations for assets which are more likely to be sold (or experience a realisation event) within the initial 5 years.	• Only delays the valuation costs for five years (or earlier if the asset is subject to a realisation event within the five years following Valuation Day) • May be practically difficult to establish what an asset was worth five years ago (as the asset may have changed or the relevant data on comparable assets may become more difficult to obtain) • May increase "lock-in" to existing assets during the first five years following Valuation Day as there will be compliance costs associated with getting the asset valued prior to it being sold. • Potentially increases opportunities for taxpayers to manipulate valuations to minimise gains or maximise losses. • Potentially increases risk of disputes with Inland Revenue over valuations.

[6] Revenue Canada, *Capital Gains Tax Guide* 1988, pg 24

[7] If no valuation had been obtained after 3 years, the straight-line apportionment or 20% of net proceeds valuation methods had to be used instead.

Secretariat recommendations

66. In order to reduce the compliance costs associated with valuation day, the Secretariat recommends:

    - Allowing the valuation to be determined at the time of the realisation event by using a straight-line apportionment based on the years the asset was owned before and after Valuation Day; and

    - Allowing an estimated market valuation for Valuation Day to be obtained up to five years after Valuation Day.

67. The Secretariat considers that providing this flexibility alongside the simple valuation methods for listed shares and real property and the exclusion for personal assets (other than baches) and the excluded home, could make Valuation Day much less of a compliance issue.

3.8 Ongoing valuation issues after valuation day

68. For most assets purchased after valuation day, the cost base will simply be the purchase price.

69. However, there could still be valuation costs for certain assets that were gifted or purchased from an associated party as it could be necessary to determine the market value for these assets. Similar market valuation rules already apply to revenue account property such as depreciable property or trading stock.

70. It will not be necessary to do this if the transaction qualifies for rollover (such as a transfer on death, a transfer from a spouse or the business reorganisation rollovers). Instead if rollover treatment applies the new owner will need to know the cost base of the previous owner.

71. As discussed earlier in this chapter, it should be fairly easy to determine the market value of listed shares and real property. The main valuation difficulties will arise for unlisted shares, closely held businesses and intangible assets such as goodwill or intellectual property. However, it should be relatively rare for these assets to be sold or gifted to an associated party in circumstances that do not qualify for the rollover for inheritances or business reorganisations involving the same economic owner.

72. Valuation costs may also arise in respect of certain assets that move into or out of the tax base.

73. The Group has decided that two apportionment options will be available when there is a change of use involving an excluded home (e.g. to a rental property or vice versa). The first apportionment option would involve determining a market value for the date that the change of use occurred. However, to reduce compliance costs the house owner can alternatively do a straight-line apportionment based on the portion of time the house qualified as their excluded home.

74. Migration can also lead to a need to determine a market value for some assets. However, since New Zealand retains an ability to tax New Zealand real property or business assets that are owned through a New Zealand permanent establishment, it could be expected that most hard to value assets remain in the New Zealand tax base and so would not need to be valued if their owner migrates offshore.

75. The experience in other countries suggests valuation is a key source of cost, uncertainty and disputes. One of the Australian practitioners we spoke to estimated that 40% to 50% of capital gain disputes they had been involved in were valuation disputes. Another practitioner noted that a key aspect of valuation was determining what type of assets were being valued and that many existing valuation systems were ill-suited to making capital gains valuations (some other relevant comments from the Australian practitioners are noted in chapter 6).

76. The ATO allows taxpayers to apply for a ruling on the market value of an asset, but this ruling service is rarely used. A 2015 review of the *ATO's administration of valuation matters* found that during the 2.5 years between July 2011 to 31 December 2013, the ATO sought valuation advice in relation to only 17 private rulings.

4. Ongoing compliance costs

77. Introducing a tax on capital gains will increase overall compliance costs on an ongoing basis as there will be more valuation activity, record keeping and need to file tax returns.

78. The major compliance costs on an ongoing basis are likely to be from keeping records of cost basis (including additions to cost basis), determining whether the tax applies, and satisfying new legal tests that form part of the rules. As an example, this would include new legal tests relating to the treatment of gains and losses in shares in a company where the tax system should avoid double taxation and double deductions, or value shifting rules that prevent people avoiding realisations by altering share rights.

79. Certain areas of tax could become simpler as a result of taxing more capital gains – for example questions of whether assets are held on capital or revenue account would become less important and some existing complex regimes such as the land rules could be simplified.

4.1 Compliance costs for different types of assets and taxpayers

80. The type, size and incidence of the compliance costs will differ for different types of assets and taxpayers.

Only a small percentage of taxpayers realise capital gains or losses each year

81. Most individuals and companies will seldom need to include capital gains in their tax returns – in Australia only 4% of all individual taxpayers and 3% of company taxpayers filed returns which included a capital gain or loss in 2015-16.[8]

82. Also as Professor Chris Evans noted in his report to the Group:

> *"...most taxpayers, whether personal or business, are not significantly affected by CGT.*
>
> *Hence the research [from Australia] shows, for example, that SMEs [businesses of up to \$50m of turnover] spent – on average – only 4 hours per annum (out of a total of 185 hours spent on tax compliance cost activities) on CGT matters.[9] ...For large*

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[8] Secretariat calculations using CGT Table 1 and Snapshot Table 6 of ATO data published at https://data.gov.au/dataset/taxation-statistics-2015-16/

[9] P Lignier, C Evans and B Tran-Nam (2014), "Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector", Australian Tax Forum, Vol 29 No 2, pp 217-247, at p 238 (Table 9).

corporations, CGT accounted for only 2.1 per cent of tax adviser costs and 2.6 per cent of internal staff time spent on tax activities.[10]"

Managed funds

83. Managed funds such as KiwiSaver providers will bear the compliance costs on behalf of their investors (although some of these costs may be passed through in the form of higher fees). The major costs on managed funds will be the initial costs of extending their existing systems for unit-pricing so they can also correctly account for the tax on New Zealand shares and ASX-listed shares.

Listed shares

84. Investors and shareholders who directly invest into listed shares will generally have good records through their custodians or online share portals. Direct shareholders may need to keep track of any losses to be carried forward if they have realised losses in years without offsetting realised gains (if loss ring-fencing is applied to portfolio shares, as recommended by the Secretariat).

85. There are existing software-as-a-service products that automate the complex calculations[11] required under the foreign investment fund (FIF) rules, and it is likely these would be adapted to also automate the record-keeping and calculations required under the new tax. If investors do not want or are not able to carry out the calculations themselves, they may have to pay for such a service.

86. Having a combination of foreign shares on which the FIF rules apply, and New Zealand and ASX-listed shares that are taxed on dividends and realised capital gains could be complicated and confusing for some investors. However, this can be mitigated by tools and guidance. For example Inland Revenue already provides an online tool that informs investors if their Australian shares are exempt from the FIF rules (and are instead subject to dividend taxation). In addition, natural persons with less than $50,000 of foreign shares are not subject to the FIF rules (unless they choose to be) so will have the same tax treatment (dividends and realised gains) on all their shares.

87. When a person buys the same share on different dates it may be complex to determine which shares are sold. Australia does not have prescriptive rules for such cases so investors are able to choose either a "first in, first out" method (the oldest shares are considered to be sold first) or track the particular shares which are sold, based on whichever approach is easiest to apply. This is an issue that the Secretariat has recommended be investigated further as part of the generic tax policy process.

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[10] C Evans, P Lignier and B Tran-Nam (2016), "The Tax Compliance Costs of Large Corporations: An Empirical Enquiry and Comparative Analysis", Canadian Tax Journal Vol 64, No 4, pp. 751-793, at pp 778-779 (Tables 5 and 7).

[11] Calculations can become complicated under the FIF rules if, for example, shares are bought and sold within one year

Real property

88. Residential and commercial property landlords will already be maintaining records and filing annual tax returns in respect of their rental income and associated expenditure. With a tax on capital gains they will be required to keep records of any capital expenditure in order to be able to calculate the net capital gain when the property is sold.

89. The original purchase price of real property is available through the sales databases maintained by Quotable Value, Trade Me and other providers, but property owners who owned their property on Valuation Day will also need to know their Valuation Day value. As discussed in chapter 2 there could be a number of valuation options for reducing the Valuation Day compliance costs for land.

90. Some landlords may own buildings on which they have claimed building depreciation (before building depreciation was removed in April 2011). Such building owners will already be required to calculate depreciation recovery income when they sell their building and the record-keeping and calculation required by the capital gains tax will be similar so the additional compliance costs should be small.

91. Most property developers as well as anyone who sells residential property that they have owned for less than 5 years will already pay income tax on their gains under the existing tax rules so will face no additional compliance costs under the new tax.

92. Owners of holiday homes or second houses that don't qualify for the excluded home exclusion will need to begin to keep records and file returns if they sell their property. There could be complications for people who inherit holiday homes which are later sold as they may not have records of previous valuations or capital expenditure. However, if they determine the market value of the property on Valuation Day they will only need to access records of capital expenditure that was incurred after Valuation Day.

Individuals

93. Based on the Australian experience less than 5% of individual taxpayers are likely to have a realised capital gain or loss in a particular year. However, there will still be compliance costs on these taxpayers on understanding their obligations, applying the rule, calculating their realised gain or loss and filing a tax return. In many cases the actual tax paid by individual taxpayers could be quite small.

94. In his report to the Group, Professor Chris Evans recommends that the Group:

    "Consider the introduction of a non-cumulative annual exempt amount (AEA) for personal and possibly certain trust taxpayers. This AEA (comprising a threshold figure between NZ$1,000 and NZ$20,000 together with a capital proceeds test of double the threshold) would considerably reduce the number of taxpayers required to compute gains and submit returns each year, and hence considerably reduce CGT recurrent compliance costs."

95. Professor Evans notes that the UK and South Africa operate an AEA. The UK's AEA is £11,700 (approximately NZ$22,500 at November 2018 conversion rates). South Africa's is set at R40,000 (approximately NZ$4,100 at November 2018 conversion rates).

96. Professor Evans also cites some research conducted in relation to the 2012-2013 fiscal year on the impact of introducing an AEA of either $1,000 or $10,000 for Australia.[12] The resulting reductions in individuals who would need to pay CGT and the GCT revenues that were estimated by this research are shown in the table below:

AEA amount	Percent of Australian individuals with a net CGT gain who would no longer need to pay CGT	Percent of Australia's net CGT revenues
AU$1,000	43% of individuals with a net gain	2% of CGT revenues
AU$10,000	71% of individuals with a net gain	10% of CGT revenues

97. The Secretariat notes that the New Zealand context is quite different to Australia. Australia taxes capital gains on collectibles (acquired for more than $500) and personal assets (acquired for more than $10,000), whereas New Zealand is proposing to exclude collectibles and personal assets from the tax base. This means that listed shares would be the main category of assets which would qualify for an AEA.

98. 31% of Australian adults directly owned listed shares in 2017.[13] In contrast only New Zealand only 18% of New Zealanders aged over 15 directly owned shares (including closely-held shares) in 2015.[14] All of this suggests the compliance cost benefits of providing an AEA in New Zealand would be much smaller than for Australia.

99. Providing an AEA could reduce the fairness and integrity of the tax, particularly if a larger threshold were provided. For example, it would provide incentives for investors to sell shares each year up to the amount of the threshold to make the most of the exemption. It would also provide a tax incentive to hold shares directly rather than through a managed fund such as KiwiSaver.

Secretariat recommendation

100. The Secretariat recommends the Group consider the advantages and disadvantages of an annual exempt amount for individuals.

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[12] C Evans, J Minas and Y Lim (2015), "Taxing Personal Capital Gains in Australia: An Alternative Way Forward", Australian Tax Forum, Vol 30 No 4, pp 735-761

[13] ASX Australian Investor Study 2017. https://www.asx.com.au/education/2017-asx-investor-study.htm

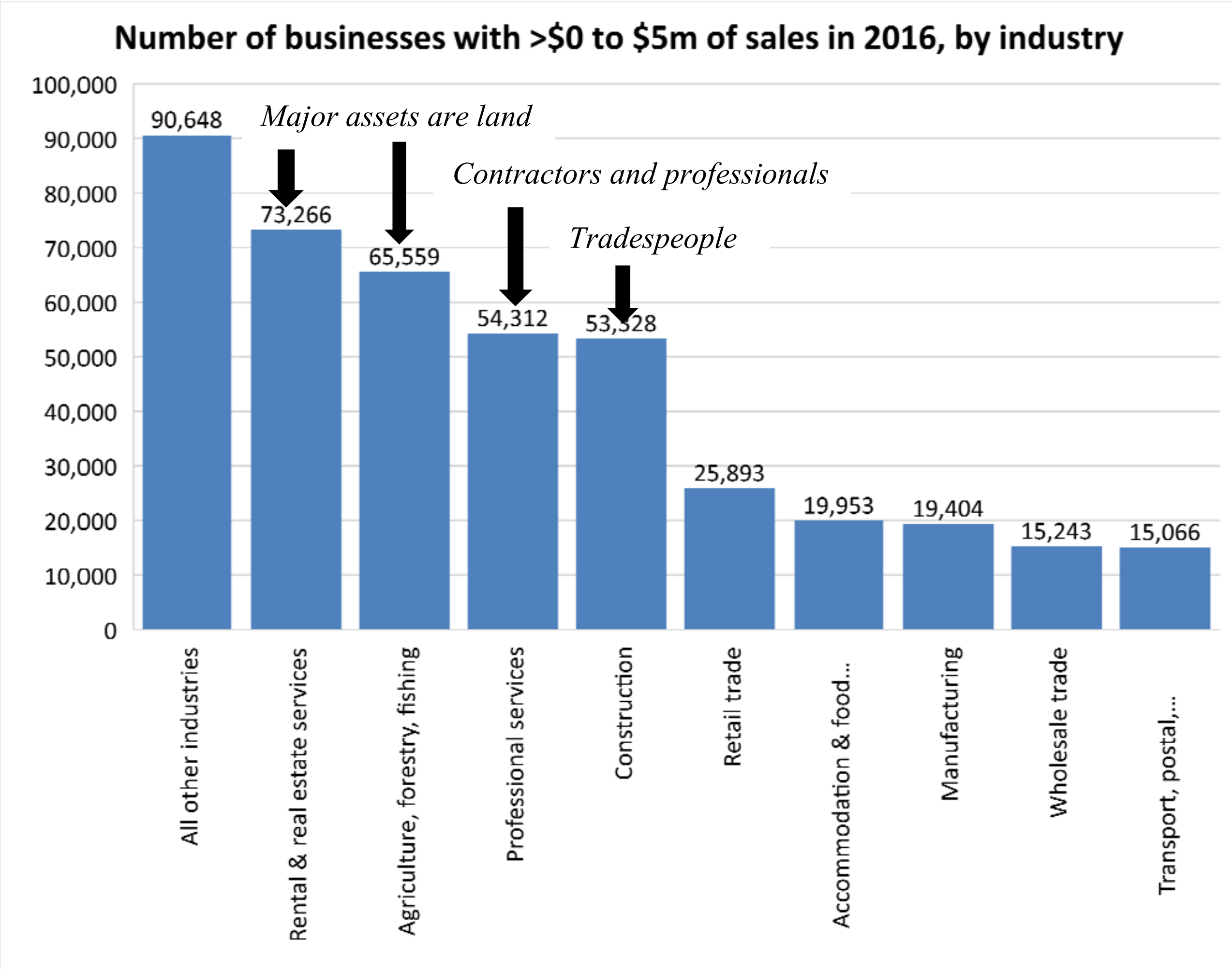
[14] Statistics New Zealand, Household Net Worth Statistics, year ended 30 June 2015. Table 1.02.

Small businesses

101. Most small businesses should have few, if any appreciating assets (such as land or goodwill) and any taxing events should be rare, for example selling their farm or business premises or selling their entire business (for example upon retirement).

102. Farmers will typically own their land. The compliance costs associated with land are described above and are generally low compared to other types of assets.

103. Among other types of small businesses it will be more common to lease their premises. As shown in the chart below a significant proportion of small businesses are contractors, professionals or tradespeople who may not own a business premises and should typically have only a small amount of goodwill.



Source: Statistics New Zealand, Annual Enterprise Survey 2016

104. One sector where capital gains are more relevant is technology start-ups whose business is about creating high-value intellectual property and who sell shares to bring in angel or venture capital investors or to achieve a profitable exit. However, such businesses are already used to regularly valuing their business and underlying IP as part of attracting new investors and these investors are accustomed to tracking their realised gains and losses.

Large businesses

105. Large businesses will face significant record-keeping costs associated with tracking the cost base and capital expenditure associated with each of the various taxable assets such as land, goodwill, intellectual property and shares in other companies that they own.

106. They will also face compliance costs with determining whether relevant rollover provisions apply. For example in Australia and the UK large corporates usually obtain rulings that the business reorganisation rollover rules apply as the tax consequences of not qualifying for this rollover are very high and the reorganisation will not take place if it doesn't qualify for rollover.

4.2 Record keeping

107. The main record keeping obligation on businesses and their owners is the question of cost basis. Businesses will have to keep records of the cost price of any capital assets they have purchased. In many cases they will be doing this already for depreciation purposes. But there will be non-depreciable property (e.g. land) and intangible property that they have created that will require a cost basis.

108. The cost price for land is straightforward, but any capitalised (i.e. not deductible) expenditure will also have to be added to the land to arrive at cost basis. The same is true in the development of intangible property. If employee salaries or other costs have been capitalised for tax purposes (under current rules, for example), then these will be the cost basis of the capital asset. While this will require record keeping over time, the question of whether the costs should be capitalised is one that exists under the current system.

109. In the context of an owner selling shares in a business that she has created, the owner will have to keep records of capital contributions to the company, as these will form the cost basis for the shares. But an owner already has to maintain these records because the contributions represent the available subscribed capital – a tax concept relevant for the test of whether a distribution from a company is a dividend for tax purposes.

110. An additional complication introduced by taxing capital gains will be that for shareholders of closely-held companies that have grouped losses with other companies, the cost basis of the companies will need to be adjusted downward to reflect the transfer in value.

4.3 Determining whether the tax applies

111. Compliance costs from transactions will only arise when there is a question of whether there is a capital gain or loss. This will be in the context of the sale of a capital asset.

112. For many businesses the sale of appreciated assets is likely to be a relatively rare occurrence. For example, in Australia only 3% of all companies filed tax returns that included capital gains or losses in 2015-16. The major class of asset that may have risen in value over time that might be sold by a business is land. Goodwill might also be sold when a particular line of business itself is sold.

113. Businesses already pay tax on any depreciation recovery income on capital assets (when an asset is sold for more than its tax depreciation value), and a tax on capital gains would

simply extend the amount assessable beyond its original cost basis. For many businesses, aside from record keeping (discussed above), there are likely to be many years where capital gains issues do not arise at all.

114. If there were no distinction between revenue gains and capital gains (and revenue losses and capital losses), for many taxpayers the additional cost of complying with the tax would be quite low and might even be negative (i.e. it would make the current tax system easier to comply with). Every asset has a cost basis, and after a realisation the taxpayer subtracts the cost basis from the sales price to arrive at a net gain. The taxpayer then applies the tax rate to the net gain to provide an amount of tax to be paid.

115. Such a system contrasts with what happens currently. Because the tax system currently does not tax gains of a capital nature, the cost of complying with the income tax can be high. Under our current system, it is very important whether or not a gain is of a capital nature or not. It determines whether tax is payable. This can result in a lot of costs determining the legal question of whether or not an asset is held or revenue or capital account. Currently, taxpayers will often apply for rulings from the Commissioner of Inland Revenue on whether an asset is on revenue or capital account if the relevant amount is large. If the taxpayer is a company, it also has to keep a record of capital gains and losses to determine the amount that it can distribute tax free on liquidation.

116. Over the two years to 30 June 2018, 9% of all taxpayer rulings requested of the Commissioner of Inland Revenue were about whether a receipt was capital (and not taxable) or revenue (and taxable), and 16% were about whether an expense was capital (and non-deductible) or revenue (and deductible).

117. We point out the above to illustrate that bringing capital gains into the tax system may make some issues simpler. However, it also introduces a number of new complications.

118. Partial inclusion rates, loss ringfencing, rollover relief, and exemptions all modify the general position that an amount is a gain or loss that is brought to account for tax purposes.

119. Partial inclusion rates (e.g. taxing capital gains at half rates) requires the assessment of whether an amount is a capital amount (and therefore taxable at half the rate) or a revenue amount. It can also drive other compliance costs.

Partial inclusion and the Australian experience

One of the Australian practitioners that the subgroup had a discussion with pointed out that because capital gains are taxed at full rates to companies but half-rates to individual shareholders, there is no shareholder who would prefer that a gain was taxed at the company level instead of the shareholder level. As a result, if a company wants to dispose of a business that has a capital gain, the company will often structure this in such a way that the business sits in a company that can be spun off to the shareholders of the original company. In this way, if shareholders want to keep their interest in the business they can, if they want to sell it they can receive favourable capital gains treatment at half their marginal tax rate.

The Australian practitioner noted that large corporates applied to the ATO for class rulings to provide certainty that these business reorganisations qualified for the rollover relief for de-mergers or scrip-for-scrip transactions. The advice and preparation of such rulings involves compliance costs. A list of public rulings published on the ATO website indicates that 122 of these class rulings for rollover relief had been issued since 2006.[15]

To the extent this is driven by the different tax treatment of companies and shareholders, the compliance costs may be reduced by taxing shareholders on capital gains at their marginal rates. Of course, spinoff transactions will still happen, and may even be driven by tax treatment (to defer tax until a realisation of their choosing for shareholders who have a low cost-basis or because of non-resident or tax-exempt shareholders), but this may be a less important consideration than the half rate issue specifically raised by the practitioner.

120. Rollover relief requires a taxpayer to determine whether the sale of an asset is a capital asset, the proceeds of which may be reinvested in a qualifying rollover asset (which itself requires determining) so taxation can be deferred. Capital loss ringfencing requires taxpayers to determine whether a loss is a capital loss (and therefore ringfenced), or a revenue loss (and not ringfenced). Small business or other exemptions require the taxpayer to determine whether they meet the exemption criteria. The rest of this chapter looks at capital loss ringfencing, rollover relief and exemptions in more detail.

4.4 Rollover relief compliance costs

121. The design of rollover reliefs will be fundamental to the questions of overall compliance costs. Compliance costs can be split into those that are an inevitable part of raising tax revenue, and compliance costs that are incurred for the purpose of ensuring no tax (or less tax) is paid. Compliance costs to qualify for rollover reliefs fall into that latter category and as a consequence seem particularly wasteful.

122. The Group has decided to recommend rollover relief for the following scenarios:

- reinvestment after compulsory acquisition or the receipt of insurance proceeds as a result of natural disaster or other event outside the asset owner's control
- business reorganisations under the same economic owner principle
- all transfers to marriage, civil union or de-factor partner (including on dissolution of the relationship)
- some rollover on death (for either illiquid assets or all assets) and potentially gifting
- reinvestment either for like-for-like business assets or into another type of active asset for small businesses with less than $5m of annual turnover (averaged over the last 5 years)

[15] ATO Legal Database – browse public rulings by topic

- Transactions relating to recovery by Māori organisations of ancestral land that was lost as a result of historical Crown actions and for transfers of assets within an iwi to their hapū or marae.

123. Each of these rollovers will add to the complexity of the legislation and necessitate additional record-keeping to ensure the original cost base is retained over time as assets are replaced or transfer to new owners. Also as some of these rollovers are within the control of the taxpayer there are opportunities for "cherry picking" by rolling over gains and realising losses. This will necessitate additional loss ring-fencing or other anti-abuse rules which would add to the compliance costs associated with rollover.

124. In terms of the design of the rollover relief itself, there are choices that are likely to have greater or lesser compliance costs.

125. In general the more complex the eligibility criteria are for qualifying for the rollover, the more likely it is that taxpayers will need to obtain professional advice or rulings as to whether they qualify for the relief.

126. For example, large corporate taxpayers in Australia and the UK obtain rulings for any significant corporate restructuring (such as a scrip for scrip takeover, merger or de-merger) that the deal will be eligible for the relevant rollover reliefs. This is because the consequences of failing to qualify are high. Australian practitioners said that these deals don't go ahead without a positive ruling.

127. A significant design choice is whether the reinvestment must be into a "like-kind" or similar replacement asset. If this is a requirement, compliance costs are likely to be greater as taxpayers have to be able to show the Commissioner of Inland Revenue that the asset they have purchased is sufficiently similar to the one they disposed of so that they qualify for the rollover relief.

4.5 Capital loss ring-fencing compliance costs

128. Loss ring-fencing rules create boundary issues and therefore increase complexity and compliance costs. Ring-fencing capital losses to capital gains requires an assessment of whether an asset is "capital" or not. Taxpayers will want to argue that assets that have fallen in value are revenue assets, and the Commissioner of Inland Revenue will scrutinise and possibly challenge some of these descriptions. As a consequence, taxpayers will face compliance costs in proving their case.

129. Because loss ring-fencing increases compliance costs (and has other disadvantages), the Secretariat's advice is to limit loss ring-fencing as much as possible, while still ensuring the integrity of the tax base. The Secretariat has provided the Group with a separate paper with our advice on loss-ring fencing.

4.6 Small business concessions

130. The OECD notes that *"when introducing special tax rules for SMEs, care should be taken to ensure that these measures do not increase complexity. The costs associated with tracking eligibility, keeping specific records and interacting with the tax system for multiple different preferences or simplification measures can increase the complexity of*

the system. In this regard a simpler general tax system may be more advantageous to SMEs than a series of simplification measures".[16]

131. Professor Chris Evans' report to the Group reiterates this OECD advice in light of Australia's experience with small business CGT concessions. Indeed, all of the Australian practitioners we spoke to advised against introducing small business concessions because of concerns about their complexity and tax integrity issues.

132. One of Professor Evans' recommendations to the Group was:

"Do not introduce special regimes for the SME sector on the basis of compliance cost considerations. If it is decided, on other grounds, to introduce special concessions for the SME sector, be very clear on the rationale for the concession (to enhance economic growth or to fund retirement?) and seek to minimize the compliance cost impact by clearly legislating the provision(s) in relation to definition, eligibility and consequences. Avoid the confusion and high compliance costs of the Australian CGT small business concessions."

133. The Secretariat agrees that it is difficult to design rules for small business concessions that would actually be effective at reducing compliance costs. One attempt at this was the option discussed in chapter 3 of grandparenting pre-CGT assets for small businesses only. However, due to the unfairness and complexities that this option would create the Secretariat does not recommend proceeding with it.

134. Instead, the Secretariat agrees with the OECD and Professor Evans that it will usually be better to try to reduce compliance costs by making the general tax rules as simple as possible, rather than having special rules for small businesses. So, for example chapter 3 recommends some ways to reduce valuation-related costs more generally such as allowing the relevant valuation to be obtained after valuation day and providing a straight-line apportionment method.

135. At their last meeting, the Group decided to recommend applying the reduced KiwiSaver tax rates to the first $1m of capital gains made by business owners who sell a closely-held business that they have owned for at least 15 years in order to retire once they reach retirement age (60 years or older). The compliance costs associated with this concession will depend on its detailed design – it will be important to ensure the eligibility criteria are simple, certain and easy to apply to common fact scenarios.

136. Australia's small business concessions are generally viewed by practitioners as being complex to apply and the various thresholds, four types of concession and frequent law changes can be confusing for the target group of small businesses. The Board of Taxation is currently reviewing Australia's small business concessions and is due to report back in 2019.

137. The Australian experience is that businesses generally try to qualify for small business treatment whether or not they are within the intended target zone for the policy, and

[16] OECD, (2015), Taxation of SMEs in OECD and G20 Countries, Paris: OECD Tax Policy Studies, No. 23, at p 15.

sometimes amendments to the law are required to limit abuses. For example, some integrity measures to stop certain taxpayers from structuring into the CGT small business concessions were announced in the 2017/18 Budget. Over time this dynamic tends to create complicated law, which in turn increases compliance costs.

138. In a 2005 post-implementation review of Australia's small business concessions the Board of Taxation reported that the average compliance costs for a business claiming the small business CGT concession was AUD$1,261 in 2002-03.[17] The same review found that the compliance costs were higher for tax practitioners who were advising on the small business concessions, at an average of $4,873 per client. The same review also found that for taxpayers who needed to undertake asset valuations for the purpose of claiming the small business CGT concessions, the average costs were $536 in 2002–03.

4.7 New rules

139. As set out in the *Domestic share issues with taxing more capital gains* paper that was considered at session 22, there are issues associated with sales of shares that require some complicated solutions. There is no doubt that these rules will end up being very complicated, and will be difficult to comply with, and will have high compliance costs.

140. In particular, if a purchaser of a company with unrealised gains must or is able to take the cost basis of the shares to be the cost basis of the underlying assets, the double taxation issue will be resolved. However, these sorts of rules tend to have high compliance costs because they are very complicated in their operation. It is likely that taxpayers who engage in these sorts of transactions (which are not unusual) will require sophisticated and expensive advice to ensure that they are complying with their obligations.

141. Another area that will likely have complicated rules is in relation to value shifting. If value in a company can be allocated to different parties by altering the rights in the share in return for payment, then taxpayers will be able to avoid "realising" shares while still unlocking cash by, in effect, selling rights. Rules to trigger realisations when there have been value shifting events are then need to counter these arrangements.

4.8 Simplifying existing rules

142. While taxing capital gains will inevitably require some complicated new regimes, it may allow for the simplification of existing complicated regimes. One area which can be quite complicated is the current provisions that tax gains on land in particular circumstances. If all land gains were taxed then these could be simplified significantly.

4.9 Third party software providers

143. Some of the compliance costs that would be imposed by the tax such as valuation and record-keeping create commercial opportunities for software providers to develop services for reducing these costs. For example, in other countries software services are available for automating dividend and capital gains tax on listed shares (including historic

[17] http://taxboard.gov.au/files/2015/07/small_business_CGT_final_report.pdf, pg 141

values going back to 1985 in Australia). Similar software also operates in New Zealand in relation to the FIF rules, so this would likely be updated to also cover those shares which are taxed on capital gains.

144. As discussed in chapter 2 the existing property valuation software services could be used to efficiently generate low cost and accurate valuations on residential rental properties for Valuation Day. Finally, Inland Revenue could provide calculators and useful data such as the Valuation Day values for NZX-listed and ASX-listed shares on its website in order to assist customers to comply.

5. Australian practitioners' views on compliance costs

145. The discussions with Australian practitioners covered a variety of issues, and the following notes focus on the comments they made relating to compliance costs. These notes are anonymised and grouped into topics.

5.1 Compliance costs generally

146. Australian practitioners noted that a CGT increases overall compliance costs as there is more valuation, record-keeping and tax returns than without a CGT.

147. That said, the compliance cost differ for different types of asset and taxpayer. For example, practitioners said that managed funds can manage the compliance costs for their investors and shareholders who directly invest into listed shares will generally have good records through custodians or share portals. For other assets they said it can be challenging to go back in time to find historical cost. For example, there may be poor records for holiday homes.

5.2 Main sources of compliance costs

148. The Australian practitioners thought compliance costs were caused by rate differential (according to practitioner 3; practitioner 2 disagreed), integrity measures (practitioner 2), exceptions (practitioner 3), prescribing how to calculate gains (practitioner 3), and choices (practitioner 3).

149. Practitioner 1 said that consolidation and CGT work is an enormous part of their practice. Transactions revolve around class rulings and there are a significant number of these rulings each year.

150. Practitioner 2 thought most of the complexity in the Australian rules came from ensuring integrity (rather than through the discounted rate).

151. Practitioner 3 said that two big aspects of compliance costs came from rate differentials and exceptions, and that they expected compliance costs would be lower if Australia did not have those. The third big aspect of compliance costs came from trying to prescribe calculation of the amount of gain – e.g. if a person's profit from a sale looks different from their taxable "capital gain". This could be caused by attempts to recapture deductions that occurred at different times but haven't been accounted for properly in the past.

152. Practitioner 3 also said that a lot of the Australian rules allow choice, which adds to complexity and compliance costs. For example, people may need to keep parallel records because they don't know which choice they will take until later. They suggested that choices be avoided where possible.

5.3 Aligning tax rates and loss ring-fencing

153. Australia provides a 50% CTG discount for non-companies which have held an asset for at least 12 months.

154. Practitioner 3 considered compliance costs could be materially lower if capital gains were treated the same as other income. In particular, if no discount was applied and capital gains were taxed at the same rates as other income then it may not be necessary to ring-fence losses. The argument for ring-fencing capital losses is that person can choose to defer gains, realise losses but this is true of many revenue gains too.

155. In contrast, Practitioner 2 was concerned about the potential revenue leakage if capital losses could be used to reduce tax on ordinary income and considered loss ring fencing was a necessary integrity measure.

5.4 Valuation issues

156. See paragraphs 34 to 40 in Chapter 2 for a summary of views expressed on Australia's approach of grandparenting pre-CGT assets.

157. Practitioner 2 expressed concerns that a Valuation Day approach could lead to a higher number of disputes.

158. However, there are still a lot of disputes in Australia related to valuation issues. Practitioner 2 noted that 40% to 50% of capital gain disputes they had been involved in were valuation disputes. The disputes can also be large and costly - the difference in valuation in one dispute was the size of the Australian government's budget deficit and this dispute ran for four years. However, it was noted that the Australian case law on "market value" was not useful for providing guidance as it is specific to each case.

159. Practitioner 2 noted that a key aspect of valuation was determining what type of assets were being valued. Practitioner 3 also described issues with intangibles and determining if something is goodwill or something else connected with goodwill.

160. Practitioner 2 also noted that many existing valuation systems were ill-suited to making capital gains valuations. Professional valuers are used to valuing assets for takeovers or sales compared to CGT assets. There is inadequate information for establishing historical cost in nearly all cases and corporate systems of accounting for cost were not suited for establishing CGT cost.

5.5 Large corporations

161. It was noted that large corporates in Australia rarely paid capital gains tax. This was because they did not generally sell appreciating assets such as a successful part of their business as it is generally preferable to continue to run a successful business division than sell it. Accordingly, any capital losses were considered to have no value for large corporates.

162. If a large Australian corporate wants to divest of a successful part of its business it is common to use de-mergers as these qualify for rollover relief as they do not involve a change in ownership.

163. Australian practitioners considered that Australia had developed a good set of rollover rules for corporate reorganisations and that New Zealand should look to copy. These ensured that the tax did not block commercially sensible business reorganisations.

164. However, there are still significant compliance costs from complying with these rollovers. For any significant corporate transaction there is a public ruling from the ATO (class ruling) that the business reorganisation rollover applies. If the corporate reorganisation doesn't qualify for rollover it doesn't go ahead.

165. As a result of Australia's CGT discounts and this rollover relief, large businesses don't sell assets but instead apply the de-merger rollover rules to separate out any business divisions they may want to sell so any tax would be paid by the shareholders if and when the shareholders decide to sell their new shares. This is because there is a 50% CGT discount for individual shareholders so a listed company paying tax at the full company rate would always produce a worse tax outcome than the shareholders paying tax at their discounted rates.

166. Before Australia introduced tax consolidation (in 2002), they relied on lots of CGT provisions to prevent duplication of losses within capital groups (these rules still apply outside of consolidated groups). Practitioner 2 said the some of these rules (for dealing with multi-tiered losses) were some of the most complex rules in the Australian regime and the immense complexity was one of the drivers for moving to consolidation. Practitioner 1 considered these complex rules dealt with something done by relatively few corporate groups. The tax consolidation system had worked well in that, within corporate groups, transfers generate no capital loss at all; and there is only tax if there is an external transaction for cash.

5.6 Small business concessions

167. All of the Australian practitioners recommended against adopting any small business concessions. They noted that Australia's concessions were politically driven and reflected the concessionary approach to taxing retirement savings in Australia. It was noted that since New Zealand did not have tax concessions for retirement savings, it did not need to have any small business concessions.

168. The policy rationale for providing small business concessions was considered to be weak. For example, rather than facilitating business growth, the small business turnover threshold arguably discourages expansion of small businesses beyond $2m of sales. Also if the objective is to match the tax concessions for other types of retirement savings this had become misaligned as although a lifetime cap had been placed on the use of other retirement concessions, the main small business retirement concession for assets owned longer than 15 years was still uncapped.

169. The small business concessions were viewed as very complex to apply and the various thresholds, frequent law changes, and four types of concession made the concessions confusing for the target group of small businesses. It is suspected that many businesses are applying an exemption (by assuming they qualify) even though they may not technically qualify under the actual rules. On the other hand, some of the wealthiest taxpayers were structuring their affairs to be able to qualify for the "small business" concessions when they are not the intended target group.

170. It was noted that the policy settings for the concessions kept changing over time which reflects the trade-off between preventing misuse of the concessions (which added complexity to the rules) and attempting to simplify the rules.

5.7 Rollover generally

171. Practitioners noted that Australia had a large set of rollover provisions and these had grown over time.

172. Practitioner 3 saw rollovers as significantly increasing complexity and creating distortions or avoidance opportunities. Another issue with rollover was that there are too many - they didn't know exactly how many because some rollover provisions are outside of the CGT provisions (and some are even in non-tax law).

173. Practitioner 1 admitted that rollover was a bit of a patchwork but thought that overall it formed a coherent body. For example, although there were a lot of different rollovers for business reorganisations generally there was rollover if a transaction did not involve the release of cash.

5.8 Inheritances and gifts of taxable assets

174. Practitioner 3 considered Australia's rollover rules for inherited assets were complicated. Due to rollover, people inherit a cost base but often don't have information that they need to practically comply with the rules.

175. Because there is rollover on death but not gifting people tend to hold onto assets on death. However, Practitioner 1 considered it would be rare for a person to gift taxable assets while they are still alive in any case (even in the absence of the tax).

176. The market value rules for gifts and non-arm's length transactions were considered necessary to prevent tax minimisation but Australia's rules may be overly prescriptive, which increases complexity.

Appendix: Design of a small business concession for grandfathering pre-CGT assets

1. Although the secretariat does not recommend a small business grandparenting concession if this was chosen a number of decisions would need to be made.

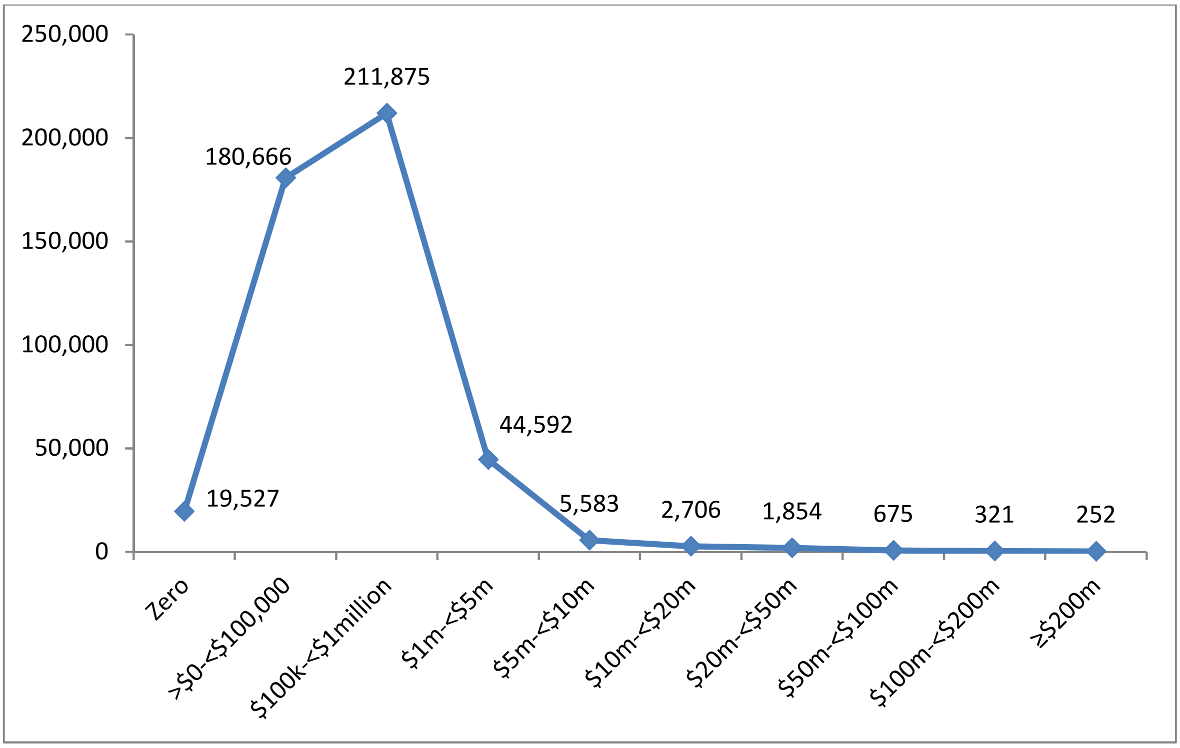
Defining a small business

2. If a small business can access concessional treatment it is necessary to define a small business and that this definition is robust as international experience suggests that businesses that would ordinarily not meet the small business threshold will attempt to structure into the small business definition to reduce the tax impost on any eventual sale.

3. The Secretariat has not yet attempted to identify exactly how many businesses would be covered by each of the thresholds suggested below. Obviously, the level of any threshold could be adjusted so the desired number of businesses could be targeted.

4. As shown in the following chart 88% of businesses had annual sales of less than $1m in 2017, which suggests that targeting the concession at businesses which average about $1m of annual turnover may be an appropriate starting point. We are aware that the Group suggested a $5m of annual turnover figure for a small business rollover, but it is important to consider that excluding pre-CGT assets is a far more generous concession than rollover as it is effectively an exemption (for the first realisation event which could be a sale of the entire business), rather than a deferral of the tax.

Number of businesses in each sales band, 2017 Financial Year



Statistics New Zealand, Annual Enterprise Survey 2017 Financial Year

5. A small business could be classified as one where:

- the turnover for the five years prior to valuation date is below $5 million (i.e. an average of $1 million per year); and

- Turnover over the same five-year period is at least $100,000 (i.e. an average of $20,000 per year).

6. The first of these requirements is designed to limit the small business definition to small businesses. Where a business has not operated over the entire test period the threshold should be apportioned so that a business that has been operating for less time is not advantaged over a firm with the same level of sales and is otherwise similar except for having operated for a longer time.

7. While there is some risk that a business at the margin may seek to lower their sales immediately before Valuation Day to remain inside the small business concession this is unlikely to be material as the majority of the measurement period will have been completed before the test is announced.

8. The second restriction is designed to exclude businesses that have not reached a critical scale by Valuation Day. Without such a restriction businesses could be established in advance of Valuation Day with the primary purpose of avoiding a tax on future capital gains. A business that did not meet this threshold would either not have started or would be of a sufficiently small size that the value of its goodwill would be minimal. If the 75% asset test discussed below was included this restriction may not be necessary.

9. The thresholds above should be applied to all companies within a commonly-owned group rather than individually. This is to prevent a single business being split into multiple smaller businesses in order to remain under the threshold.

Taxation of a small business

10. A business meeting the small business definition would be eligible for concessionary treatment. The most generous of these concessions is that the entire business would not be liable for an extension of the taxation of capital gains. A less widespread approach, which the Secretariat prefers, would only tax certain assets owned by a small business, for example real property that was not an excluded home. Continuing to tax real property owned by a small business would also be consistent with the approach to taxing land-rich companies.

11. In defining the scope of the concession this could be done by inclusion or exclusion. The business could be required to only value certain assets, for example land and buildings, or could be not required to value certain assets for example intangible assets and other assets that would not be subject to the extended taxation of capital gains. The advantage of the first approach is it is simpler to draft and to understand; however, it is less inclusive so could risk assets that would be intended to be subject to the extended taxation of capital gains being put into a small business in order to avoid this.

12. A further consideration is whether to include assets acquired at some time after the Group's final report (or other later date) but before valuation day. If such assets can access the concession it could create an incentive for businesses to obtain additional assets before valuation day just to access the tax concession. However, this incentive is minimised if the concession is limited to hard to value assets as it is much more likely that a small business would try to obtain real property than intangible property, with the most likely exception being a business expanding by buying another business including its goodwill or intellectual property. Introducing a separate date for assets acquired is a small increase in complexity so the Secretariat considers this should not be necessary.

Ceasing to meet the small business concession

13. The small business concession would cease to apply when the ownership of a business changed at which point the future owner would have an easily determinable value of the business.

14. The main decision is how to treat a formerly small business that was no longer below the threshold. The two options are to treat a small business on valuation day as being a small business even if it grows above the threshold or to move the business into the new tax on capital gains when they no longer met the threshold.

15. When compared with no small business concession the second of these options would have a much smaller decrease in compliance costs as many small businesses would be expected to grow overtime in which case the compliance costs of obtaining a valuation would be deferred rather than removed, as well as the ongoing compliance costs of having to continue to monitor the threshold (which would also need to be periodically reviewed to reflect inflation). Removing the concession for businesses that grew would also create a disincentive for a business to grow in order to prevent taxation on gains up until the threshold was breached. The Secretariat therefore considers a small business concession should continue to apply to a small business that grows above the threshold.

16. Australia has two further tests for bringing pre-CGT assets within the CGT tax base:

    a) Grandfathering no longer applies if a company has a 50% or more change in shareholding.

    b) Grandfathering no longer applies if 75% of the assets of the company (excluding trading stock) were acquired after valuation day.

17. If similar tests were applied to a New Zealand small business concession it would be necessary for a valuation to be undertaken once these thresholds were exceeded.

18. The first of these tests is similar to a shareholder continuity requirement and would essentially be required otherwise a business could be sold except for a minority interest just so the concession continued. As there would be a change in ownership interests to trigger this test it should also make it easier for a valuation to be obtained at this date.

19. The second test is less necessary if the concession is limited to hard to value assets as the majority of asset growth in a small business would be expected to be in real property rather than intangibles and this would already be subject to tax. One advantage of a 75% test is

it reduces the need for a lower threshold test for entrance for the small business concession. This is because a yet to be started business would not be expected to have many assets so as soon as it started substantive trading it would typically grow above the 75% test and the concession would cease to apply. If the concession is limited to hard to value assets, whether to include the 75% test or the entrance test then becomes a trade-off between compliance costs on introduction of the tax or ongoing compliance costs.

20. Through these rules the number of businesses qualifying for the small business concession will decline over time. In Australia certain pre-CGT assets were subject to "close out" legislation that brought them into the base if they were owned by a superannuation fund in 1989 or by a listed company in 1998. There has been no equivalent rules for other pre-CGT assets such as small business assets so issues around these assets can still arise over 30 years after the CGT was introduced. However, the remaining stock of pre-CGT assets continues to decline as the owners of these assets are older people who are selling them to fund their retirement.