Purpose of discussion

This paper provides an initial overview of how New Zealand taxes capital income and discusses the role that wealth taxes could play in reducing inequality. The paper also considers two key areas where New Zealand differs from other countries in the taxation of capital – not taxing many capital gains and not providing generous tax treatment of retirement savings. The Secretariat seeks feedback from the Group to inform the more detailed future discussions on these issues on the forward agenda.

Key points for discussion

- Is capital income taxation (with a potentially broader base) an adequate basis for the taxation of capital?
- Is the direct taxation of wealth tax a desirable additional mechanism?
- To what extent should future meetings focus on:
  - Wealth taxes;
  - The taxation of retirement savings, and the role of taxation in relation to the level and quality of saving and investment;
  - The impact of inflation on the taxation of capital income.

Recommended actions

We recommend that you:

a  note that future papers will provide more detail on options for taxing capital gains;

b  indicate subjects the Group would like additional information on:

  i.  wealth taxes;
  ii. taxation of retirement savings;
  iii. impact of inflation on taxing capital income.
Taxation of capital income and wealth

Background Paper for Session 5
of the Tax Working Group

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

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

The Tax Working Group will release its interim report containing its recommendations in September and the views of the Group will be informed by public submissions alongside Secretariat advice.

March 2018

Prepared by the Inland Revenue Department and the New Zealand Treasury
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Executive Summary

The purpose of this paper is to provide an overview of New Zealand’s system of taxing capital income and some alternatives. It also provides information on a wealth tax. A key question for the Tax Working Group is whether the tax system should be doing more to reduce wealth inequality and a wealth tax is considered in this context. The paper seeks views from the Group on whether it would like more information on wealth taxes.

New Zealand taxes capital income through an income tax, which taxes most forms of capital income as it is earned. It also has an expenditure tax in the form of GST.

Capital income taxes and wealth taxes both reduce wealth inequality by reducing the rate of wealth accumulation. Few countries have annual net wealth taxes now because they are complicated to apply, apply to few taxpayers, and may encourage taxpayers to change residence to avoid the tax. Net wealth taxes may not be necessary if there are comprehensive capital income taxes, including capital gains taxes. Net wealth taxes could be used to fill a gap if the capital income tax base is not comprehensive. However, net wealth taxes increase the efficiency costs of capital taxation. The paper focuses on the following questions:

- Does the Group consider that capital income taxation (with a potentially broader base) is adequate for the taxation of capital?
- Is the direct taxation of wealth tax a desirable additional mechanism?

The paper also introduces the Group to two areas where New Zealand’s taxation of capital income is unusual internationally, its lack of a general capital gains tax, and its lack of a concessionary regime for retirement savings. Within the context of retirement savings New Zealand has been noted by some for having low levels of savings and capital investment, and a high level of investment in housing compared to financial assets, although recent data suggests that New Zealand is similar to other countries in this area. The paper asks whether there are particular areas where the Group would like more information from officials for its future deliberations on capital gains tax and the tax treatment of retirement savings.

The paper also indicates that inflation is a factor that distorts the taxation of capital income. Finally, the paper:

- Notes that the Secretariat intends to provide further information for the Group on capital gains for discussion at a later session. This includes lock-in (theory and evidence) and ways of addressing it (rollovers, lower rates), inflation compensation (accurate or proxies, such as lower rates), and loss ringfencing (efficiency issues and ways of addressing) and other design features.
- Asks if the Group would like any more information on:
  - retirement savings and for what context? Adequacy of savings levels, quality of investments, impact on income and wealth inequality from concessions?
  - the effect of inflation on capital taxation and ways of addressing it?
1. Introduction

Purpose

1. This paper provides a brief overview of the tax treatment of capital income and wealth in New Zealand. This paper is background and will be followed by more detailed papers on the taxation of capital gains and savings. The accompanying paper on distribution could also be referenced for information on the distribution of wealth.

Background

2. The income tax base includes labour income (for example, wages) and capital income (that is, income earned on things people own). New Zealand taxes labour income and most capital income under an income tax, which means that the tax does not generally vary with the type of income earned. This approach is simple and can be argued to help provide horizontal equity (people earning the same income pay the same tax). New Zealand has two unusual features by world standards: the absence of a capital gains tax, and the lack of a concessionary regime for retirement savings. These are briefly discussed in the context of distributional and investment efficiency issues.

3. The distributional context is important. There is considerable public concern about the levels of inequality. More information on the distribution of income and wealth is provided in the accompanying paper on distributional analysis. How the taxation of capital income and wealth impact on wealth distribution and inequality will also be discussed in chapter 3.

4. In addition, some commentators have indicated that New Zealand has a low level of savings, particularly private savings as public savings is high. New Zealand was thought to have a low level of savings invested in financial assets versus housing compared to other developed countries, although recent data suggests this is not the case. Some have asked if New Zealand’s lack of a favourable tax regime for retirement savings contributes to these outcomes.

5. How we tax capital income impacts a number of the four capitals. Taxing capital income discourages the formation and accumulation of private capital, affecting physical and financial capital. The balance of the tax impost between capital and labour income could also impact the formation and use of human capital. And inequality, which could be ameliorated through taxation, also impacts social capital.
Content and scope

6. Chapter 2 discusses key concepts in the taxation of capital income. It outlines some differences between the tax treatment of household savings in New Zealand and the approaches taken by other countries. Chapter 3 provides a brief explanation of wealth taxes and outlines the various forms of wealth taxes previously applied in New Zealand. It also discusses how wealth taxes and capital income taxes impact on fairness, economic efficiency, administration and compliance costs and wealth inequality. Chapter 4 discusses specific areas of interest within the topic of taxing capital income – capital gains, retirement savings, and inflation.

7. This paper is intended as an introduction to capital income and wealth tax and raises some issues to consider. Key issues and analysis of potential changes in this area, such as options for a capital gains tax, will be considered in further Secretariat discussion papers. The Group is invited to raise with the secretariat any other matters in the area of capital income tax and wealth tax that they would like information on.
2. Taxing income from capital

What is capital income?

8. When we discuss taxing income we usually categorize income into two broad categories: labour income and capital income. Labour income is income you earn performing services for someone, such as being an employee. Capital income is earned on something you own. Different types of investment assets earn different types of returns, and we often have particular tax regimes for taxing different forms of investment income. These are summarised in Appendix A. Income earned from making a loan or owning a bond is interest income, and interest income is taxed under the “financial arrangement” rules. Income earned from shares is dividend income and there are special rules for taxing those (such as imputation). Income earned from an asset appreciating in value and sold is another form of capital income, and there are a number of rules that determine when and how this is taxed.

9. Sometimes capital income and labour income are earned together and they are not easily separable. For example, someone running their own business may earn income from their own efforts, but ownership and use of assets will often contribute to the business income.

Approaches to taxing labour income and capital income

10. For years many economists have argued that there should be a lighter tax impost on the capital income of domestic residents than on their labour income. This is because they believe that taxes on the capital incomes of domestic residents can be particularly distorting through discouraging saving and also distorting the ways in which people save. Biases in the way that people save (i.e., the types of investments they undertake) are illustrated later in this chapter. Different tax regimes have been designed to address this, including Nordic taxation (a comprehensive system of having a lower tax impost on capital income than on labour income) and an expenditure tax.

11. The 2009 Tax Working Group considered a Nordic tax system for New Zealand, and did not recommend it, as at the modest company tax and personal income tax rates New Zealand currently has, any efficiency advantages it could have were outweighed by the complexity of its rules that are needed in order to classify the type of income.

12. Another main option is an expenditure tax, which effectively does not tax the normal return on capital and largely removes the distortionary effect of capital income taxation. This is discussed later and in Appendix B. Its downside is a
much lower overall revenue from taxing capital income at a given tax rate, which would require that the tax have a higher rate, or higher taxes on labour income or some other base. New Zealand does have an indirect expenditure tax in GST.

13. Something that may not have been given enough attention in the discussion until recently has been that wealth ownership has a very skewed distribution, and reducing the tax on capital income may have contributed an increasing level of inequality in many developed countries in recent years (IMF 2017).

14. This chapter discusses some of the mechanistic differences between a comprehensive income tax and an expenditure tax and some efficiency implications that they have. The next chapter discusses wealth inequality and how comprehensive capital income taxation and wealth taxation impact on wealth inequality and their broader economic effects.

New Zealand’s income tax

15. New Zealand taxes both labour income and capital income under its income tax. The tax rate depends on the type of entity earning the income (e.g., companies are taxed at 28% and individuals are taxed on a progressive scale) and does not vary with the type of income earned. Taxing capital income and labour income at the same rate is simple (for example, in the case of taxing business income that includes both labour and capital elements). There is an open question about whether or not income is the best base against which to measure horizontal equity. But if income is chosen as the base, a comprehensive income base also contributes to horizontal equity (because people earning the same income tend to pay the same tax).

16. Our income tax is often referred to as ‘TTE’ – Taxed-Taxed-Exempt. This means that capital investments are made out of income that is taxed (usually an individual’s labour income), the income earned from the investment is taxed, and amounts withdrawn from the investment are not taxed.

17. Under our “broad-base, low-rate” (BBLR) tax system, we try to capture capital income as broadly as possible and tax it as it is earned. To the extent we can do this, it promotes efficiency of investment as tax is not causing investors to choose an inferior investment because it has tax benefits. However, it is not possible to do this completely given difficulties in measuring some forms of capital income and there are two broad exceptions: imputed rents of owner-occupied housing are not taxed (although non-taxation is common internationally) and most capital gains are not taxed. Also at times capital expenditure can be deducted immediately or at least more quickly than the rate at which assets are actually
depreciating and this can lead to New Zealand’s income tax base being less than fully comprehensive.

18. The two main distortions that arise from applying New Zealand’s income tax to capital income that are commonly discussed are:

a. **Savings and consumption decisions**: Taxing capital income may influence decisions about when to consume and, by extension, how much to save at a point in time. This is likely to have an efficiency cost by causing people to save less than they would if they were required to pay the same amount of tax in a non-distorting way (such as a lump sum tax instead of a tax on income). Reducing or removing tax on capital income has a *substitution effect* that could cause people to save more since the returns to saving are higher. The tax reduction can also have an *income effect*, where the higher after-tax returns encourage the saver to consume more (save less). This is discussed further in chapter 4.

b. **Decisions about how to invest savings**: Taxing capital income may distort investment decisions if the *effective* tax rate paid on a *marginal investment* is not uniform across different types of savings. The BBLR approach is intended to minimise these distortions by keeping tax rates as low as possible and ensuring that our income tax applies broadly across different types of capital income with few concessions.

**Investment distortions resulting from New Zealand’s income tax**

19. We can understand these distortions across different forms of investment by looking at *marginal effective tax rates* on household savings. Marginal effective tax rates measure the tax rate on real, pre-tax income for investments that earn the same rate of return and will depend on a number of assumptions that are open to question.¹

20. The tax rates in figure 1 below vary because of:

- the non-taxation of capital gains when some assets are expected to earn capital gains;
- the difference between the company portfolio investment entity (PIE), and personal rates (in this analysis companies are investing in assets whose full nominal returns are being taxed. There is a range of assets that companies can invest in including property or business assets where some income may [in the exercise below it is assumed that the *risk-free* return is 3%, inflation is 2%, the real capital gain on rental property is 1% per year, and the statutory marginal tax rate is 33%].

¹
accrue as untaxed capital gains or where capital expenditure can be deducted early where marginal effective tax rates would be lower than indicated in the Figure);

- the different tax treatment of foreign shares compared with domestic shares;
- the levying of local government taxes on real property; and
- the taxation of gains that are solely due to inflation.

21. Because the tax system does not account for inflation, a 33% tax on the nominal return (i.e. the real return plus inflation) on savings in a bank account is actually a materially higher tax on the real return. As risk-free rates have declined around the world, the relevance of taxing nominal rather than only real returns has increased. This is because the inflation component is a larger proportion of the nominal interest rate. See the discussion in Appendix A for more information. The chart above assumes a 3% real risk-free rate. This is a low assumption relative to historical risk-free rates, but is high relative to current risk-free rates in New Zealand.

22. In New Zealand, economic income that is not taxed is primarily made up of imputed rent from owner-occupied housing, and capital gains. As shown in the figure 1 above, owner-occupied housing is undertaxed relative to other assets as a
consequence. It is noted that the Terms of Reference for the Group specifically exclude any recommended changes to the tax treatment of owner-occupied housing.

23. Foreign shares are relatively highly taxed under the *fair dividend rate* system, whereby income is calculated at 5% of the opening value of the shares each income year. If real returns are only 3% (as assumed), this will overtax foreign shares.¹

24. Under a broad-based, low-rate system, ideally the bars in the above chart would line up perfectly and there would be no difference in marginal effective tax rates between the types of investments. Relative to other countries, New Zealand’s marginal effective tax rates on savings are quite uniform, but there may be room for improvement to achieve more consistency and to reduce gaps in our current system. Doing this by increasing tax rates on owner-occupied housing is ruled out by the terms of reference. Another approach might be to reduce taxes on capital income generally but in that case capital income taxes would become less progressive and be doing less to reduce inequality than at present. Alternatively, we could reduce biases between investments other than owner-occupied housing by moves to increase tax rates on rental property and possibly evening out biases between bank accounts, PIEs, superfunds, companies that distribute and those that do not and foreign shares. More consistent treatment should improve both fairness and efficiency.

**Data on Amounts and Taxation of Household Investments**

25. The following table summarises the investments of New Zealand households by the amount invested and tax treatment as of 30 September 2017:

---

² Owner-occupied housing – equity has a positive tax rate (rather than 0%) because housing is subject to local property taxes (rates). In the chart above rates are assumed to be 0.34% of the market value of a property.

¹ The situation for foreign shares is more complicated as individual investors receive a $50 000 de minimis, whereby if the cost value of the shares is less than $50 000, individuals can return the dividends as income. Individuals can also use the comparative value method if the cost value is over $50 000 but the returns are lower than 5%. If the returns were 3%, individuals would pay tax on 3%. If the returns were -5%, individuals would pay no tax. These more generous options are not available for PIEs that hold foreign shares.
<table>
<thead>
<tr>
<th>Financial Assets</th>
<th>Cash and Deposits</th>
<th>Debt Securities</th>
<th>Domestic Shares (listed companies)</th>
<th>Foreign Shares</th>
<th>Investment Funds</th>
<th>Super Funds</th>
<th>Financial Assets subtotal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Amount NZ$ Billions</td>
<td>$170</td>
<td>$5</td>
<td>$121</td>
<td>$8</td>
<td>$62</td>
<td>$95</td>
<td>$460</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>10%</td>
<td>0%</td>
<td>7%</td>
<td>0%</td>
<td>4%</td>
<td>6%</td>
<td>27%</td>
</tr>
<tr>
<td>Allocated Liabilities</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Net Amount NZ$ Billions</td>
<td>$170</td>
<td>$5</td>
<td>$121</td>
<td>$8</td>
<td>$62</td>
<td>$95</td>
<td>$460</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>12%</td>
<td>0%</td>
<td>8%</td>
<td>1%</td>
<td>4%</td>
<td>6%</td>
<td>31%</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>TTE</td>
<td>TTE</td>
<td>TTE</td>
<td>TTE</td>
<td>TTE (PIE)</td>
<td>TTE (some KiwiSaver)</td>
<td>TTE</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Investments</th>
<th>Owner-Operated Business</th>
<th>Investor Housing</th>
<th>Owner-Occupied Housing</th>
<th>Other Investments Subtotal</th>
<th>Total Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Amount NZ$ Billions</td>
<td>$201</td>
<td>$265</td>
<td>$786</td>
<td>$1,253</td>
<td>$1,712</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>12%</td>
<td>15%</td>
<td>46%</td>
<td>73%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocated Liabilities</td>
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<td>$68</td>
<td>$173</td>
<td>$241</td>
<td>$241</td>
</tr>
<tr>
<td>Net Amount NZ$ Billions</td>
<td>$201</td>
<td>$197</td>
<td>$614</td>
<td>$1,012</td>
<td>$1,472</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>14%</td>
<td>13%</td>
<td>42%</td>
<td>69%</td>
<td>100%</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>TTE</td>
<td>TtE</td>
<td>TEE</td>
<td>Mixed</td>
<td>Mixed</td>
</tr>
</tbody>
</table>

26. Note that descriptions such as TTE or TtE are simplifications used for illustration. For example, there may be investments in domestic companies and owner-operated businesses that appreciate in value or earn other forms of income that are not fully taxed, which would make them similar to TtE, but the overall framework is that they are meant to be taxed as TTE. More information on the taxation of different forms of investment is in Appendix A.
Expenditure tax – an alternative approach

27. An income tax taxes income, which can be defined as a taxpayer’s consumption plus increase in wealth. An expenditure tax taxes consumption only. The difference between them is savings, and income tax taxes income that is saved and an expenditure tax does not. An expenditure tax could be a direct expenditure tax, such as a cash-flow tax, or an indirect expenditure tax, such as GST. An expenditure tax could be described as EET (Exempt-Exempt-Taxed).

28. Under an EET approach, the income that is the source of the capital investment is not taxed. (Under a direct expenditure tax or cash flow tax this would be given effect by allowing a deduction for the amount invested). The investment income is not taxed as it is earned. Amounts withdrawn – both the capital and accumulated capital income – are taxed in full. This means the labour income and investment income are both taxed on a deferred basis. This has the same affect, in present value terms, as if the labour income was taxed when it was earned and the investment income was not taxed at all.4 See Appendix B for a description of this.

29. An expenditure tax has an advantage of not distorting savings/consumption decisions, and it does not distort investment decisions, because investment income is not taxed as it is earned. However, for a given tax rate, it earns less revenue than an income tax, so tax rates would have to rise which would impose additional distortion costs. It also taxes the wealthy less than a comprehensive income tax as capital income, which is earned primarily by wealthier households, is not taxed as it is earned.

30. Many countries have a limited form of expenditure tax that applies only to ringfenced retirement savings accounts that are taxed on an EET basis. This is discussed in chapter 4.

4 In other words, EET is equivalent to TEE so long as tax rates remain constant through time.
3. Wealth taxes, capital income taxes, and inequality

What are wealth taxes?

31. There are two broad types of taxes levied on wealth: wealth taxes and transfer taxes.

   a. Wealth taxes are generally based on the value of a person’s taxable assets and are assessed periodically – usually on an annual basis. Taxable assets can be broadly defined or a subset, such as a land tax. A land tax will be discussed in a later meeting.

   b. Net wealth taxes are based on net asset values (assets less liabilities) and are usually assessed on an annual basis.

   c. Transfer taxes are assessed on a transfer of wealth (for example, on a person’s inheritance). They can be levied either on the person transferring the wealth or the recipient of it.

32. Internationally, there is a trend towards declining usage of net wealth taxes. Only five major countries in imposed net wealth taxes in 2017 (Argentina, France, Norway, Spain and Switzerland), compared to twelve countries in 1990, and many of those that do still have wealth taxes are making steps towards removing it. The Netherlands has a way of taxing capital income that is similar in practice to a wealth tax. It deems portfolio investment assets to earn a certain return, so it ends up being a flat tax on the assets value instead of trying to measure its return and tax it. Note that taxing wealth through income tax in this way allows the progressive income tax scale to apply to the wealth tax, instead of the flat scale that often applies to wealth taxes. Italy also has a limited wealth tax that applies only to foreign assets. Further material on wealth taxation practices in jurisdictions which still have them is provided in Appendix C.

33. The trend of reduced reliance on net wealth taxes reflects a number of interrelated challenges (OECD 2018):

   a. Risk of residence flight – that is, wealthy taxpayers emigrating to avoid paying wealth tax, especially given higher levels of individual mobility.

   b. Integrity issues – because net wealth is a narrow base, it can be harder to tax compared to our broader bases (income and consumption) (the tax could be avoided by owning forms of wealth that are not subject to tax). This tends to result in higher levels of evasion and avoidance.
c. Administration and compliance costs – net wealth taxes are difficult to apply for both taxpayers and tax administrations. This is becoming a lesser concern with greater information sharing between tax jurisdictions, although it will not overcome some problems, such as difficult valuations.

34. Because of these factors, wealth taxes tend to have high cost-yield ratios (that is, wealth taxes are costly to administer relative to the amount of revenue they raise) and often do not produce the redistributive effects that are intended (OECD 2018).

**Wealth taxes in New Zealand**

35. New Zealand historically had wealth taxes in the form of land tax, inheritance tax and gift duties. All of these taxes have since been repealed; gift duty was the last remaining form of a wealth tax until it was removed in 2011. A history of New Zealand transfer taxes is in Appendix D.

36. New Zealand has never had a general tax on net wealth. However, tax policy commentators in recent years have raised the role of such a tax, given concerns about rising inequality.

**Addressing inequality**

37. Globally, wealth inequality has been decreasing over the last 30 years, reflecting increasing wealth of Asian countries over this period. However, most developed economies experienced increased inequality within their own countries over this period, driven primarily by wealth increases in the top one percent. (IMF 2017). The evidence for New Zealand is not completely clear. There is some indication that globalisation may be responsible for both of these trends (OECD 2017). A number of studies have analysed whether changing tax policies may have contributed to these trends. For example, the IMF noted that a low tax impost on capital income has often been justified on efficiency grounds, to encourage high levels of investment to generate economic growth. Examples of these policies are low tax rates on capital income, concessional capital gains taxes and retirement savings incentives, as well as tax base incentives such as accelerated depreciation. However, it noted that one impact of these is to increase the rate of wealth accumulation from higher returns to capital, which tend to benefit the wealthiest households (IMF 2017).

38. A number of commentators have suggested that tax changes addressing high rates of wealth accumulation may help to reduce growing rates of inequality (Piketty 2014, Atkinson 2015). The OECD has been looking at the distributional and efficiency impacts of net wealth taxes, and comparing them to income taxes.

39. Information on wealth inequality in New Zealand is provided in the accompanying paper on distributional analysis. It shows that the distribution of wealth is highly skewed to the wealthiest households (more than the income
distribution is skewed), and the distribution of assets that generate income (financial assets and real estate other than the family home) is even more highly skewed than wealth generally.

Comments on net wealth taxation and capital income taxation

Capital income taxation and net wealth taxation

40. Discussion of capital income taxation and net wealth taxation often compare them side-by-side with equity, efficiency, and practical advantages and disadvantages of both discussed. While this helps illuminate policy issues with a net wealth tax (that is usually the novel tax base being considered, with a capital income tax usually an existing tax base), in practice, net wealth taxes are usually applied as an additional tax and not a replacement for a capital income tax. Although in theory a net wealth tax could replace a capital income tax, to do this would require disentangling labour income from capital income in cases where they are earned together (such as through a small business). This is impractical and probably not desirable for a country with income taxes at rates applying in New Zealand.

41. The discussion below does compare advantages and disadvantages of net wealth taxes to capital income taxes as a way of highlighting issues, but in practice the policy option being considered would be to have a net wealth tax as an additional tax to capital income tax (although a wealth tax which interacts with a capital income tax is discussed under partial or temporary wealth tax).

Fairness and social capital – reducing inequality

42. A key question for the Tax Working Group is whether or not tax changes should be targeted to reducing inequality in New Zealand. Net wealth taxes could be used as an instrument to reduce inequality, because the annual tax would directly reduce the assets of the wealthiest households, and provide revenue which could be used for redistribution.

43. Capital income taxes also reduce inequality by reducing the rate at which reinvested capital income accumulates.

44. In theory net wealth taxes could reduce the wealth of taxpayers even when the wealth does not produce income, such as personal items. However, in practice wealth tax regimes usually exempt many of these because they are difficult to value and do not provide cash to pay the tax (see Appendix C).

45. Capital income taxes, and capital gains taxes in particular, tax faster capital accumulations more than a net wealth tax which raises the same revenue on an asset regardless of its actual return or appreciation in value.
Efficiency and financial and physical capital – minimising distortions to investments

46. Net wealth taxes, like income taxes, cause distortions which bias savings decisions. They can also reduce economic output compared to potential output if no tax applied (Akgun, Cournede, Fournier). For a net wealth tax to operate efficiently, it should apply to all forms of wealth and be based on accurate valuations. However, all annual net wealth taxes have significant exemptions and simplified valuation rules for the base, which means the wealth tax could significantly distort investment decisions (OECD 2018). Moreover, the net wealth tax is usually applied in addition to an income tax on capital income, which means it does not alleviate any distortions caused by the income tax, and it adds new ones. If a net wealth tax exempted the family home, then this would tend to increase the difference between the METR for owner-occupied housing and the METRs for other assets. These are illustrated in the chart below:

![Chart illustrating METRs for different assets](chart.png)

47. Some have argued that an efficiency benefit of a net wealth tax is that it encourages ownership of more productive assets, since the same amount of tax must be paid on ownership of unproductive assets. However, it has also been argued that the fact that an income tax taxes higher returns (economic rents) more than a net wealth tax is an efficiency advantage of the income tax, since taxing those higher returns is less likely to deter or distort investments (OECD 2018).

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5 For simplicity, this claim is made without regard to the economic and social benefits of the government spending the revenue raised by the tax. This type of analysis is done in order to focus thinking on the best way to raise revenue, while the government’s best use of revenue is considered separately.


**Practical administrative and compliance issues**

**Defining the net wealth tax base**

48. Net wealth taxes are normally based on net wealth of households rather than individuals. This is because household wealth normally benefits all members of a household and not just the individual owning it. Because net wealth taxes are costly to comply with, and a net wealth tax would not raise much revenue when applied to households of modest wealth, it generally only applies to very wealthy households in the countries which still have them. For example, the Spanish net wealth tax applies only to household net wealth above 700,000 euros, and the French net wealth tax applied to net wealth above 800,000 euros. The French net wealth tax has been replaced by a real estate net wealth tax on amounts above 1.3 million euros.

49. Different countries have taken different approaches to what assets to include in the net wealth tax base. Real estate is usually included although there are sometimes partial exemptions or favourable rates for the family home (France, Norway, Spain). Some countries include and some exclude large durable goods such as cars, boats and airplanes. One of the largest sources of wealth for many wealthy households is shares in a closely held business. Norway excludes these as it does not want to discourage individuals from operating a business. Even when closely held businesses are included in the base, they are very difficult to value and valuation could be understated by using conservative accounting assumptions such as for future earnings (Wall Street Journal 2012). This means the level of net wealth tax applying to a closely-held company would most likely be lower than the amount intended by statute. On the other hand, if the business slumps, the net wealth tax, which unlike an income tax is imposed regardless of profits, could be very burdensome.

50. The use of family trusts is common in New Zealand and would raise important compliance issues. Are the assets of the trusts treated as if they are owned by the settlor or the beneficiaries (and which beneficiaries)? Is the trustee liable for wealth tax liability of the trust or is the settlor (or beneficiaries) liable? These would have to be addressed in the design of a net wealth tax or else the tax would be easy to avoid.

**Residence flight**

51. Because so few countries have net wealth taxes, and they generally apply only to wealthy households who have the ability to emigrate if desired, there has been comment and anecdotes that the net wealth tax causes them to flee. (OECD 2018, Washington Post 2006).
Net wealth tax as a minimum tax

52. The OECD (2018) also raises the idea of using a net wealth tax as a minimum tax which is creditable against future tax on capital income. As a minimum tax, the net wealth tax would be compared to the amount of income tax paid. If the minimum tax exceeded the amount of income paid, the difference would be paid as a tax. Since many situations of low taxation relative to wealth arise from timing differences, the net minimum tax paid should be carried forward to offset income tax paid in subsequent periods. The reverse situation also needs consideration.

53. There are three major issues that are raised with a wealth tax as minimum tax in addition to the issues discussed earlier.

- Identifying income from capital;
- Avoiding distortions across firms and assets with different profiles of risk and timing of income; and
- Dealing with income earned on behalf of individuals in other entities.

54. The difficulties raised depend upon what capital assets are to be covered by the minimum tax. These issues are particularly acute for business assets.

Identifying income from capital

55. Business income, (particularly for closely-held companies) is a combination of income from capital and income from labour. Separating the income flows is complex and generally arbitrary. Thus applying the minimum tax to business assets in a way that is consistent with its application to other forms of capital would be difficult at best. The target assets could be limited to financial assets plus real estate. This would avoid some of the problems with applying the tax to businesses, but would frustrate the goals of the minimum tax in targeting high levels of income where low levels of tax are being paid. Moreover, separating “financial” investments from “business” investments presents its own challenges.

Avoiding distortions

56. One issue with the net wealth tax as a minimum tax is that it could discourage risk-taking. If someone invests in a risky asset, they are taxed on income if the venture succeeds. However, if the venture fails, then they still have to pay a tax even though they have lost money. This is likely to discourage risk-taking more than an income tax and more than a net wealth tax that does not operate as a minimum tax (i.e., with no additional tax applying if the venture succeeds).
57. Achieving a comparable level of tax across firms in different situations would also be problematic. Start-up companies frequently do not make profits for a considerable time. Thus they could pay considerable minimum tax that could not be recouped for a long time (or ever if the start-up was unsuccessful). This would disadvantage start-ups compared to mature firms. It would be particularly burdensome when applied to entrepreneurs in risky high tech start-ups.

58. Firms in cyclical industries could also experience a higher overall tax impost relative to income than firms with more stable income streams. The problem is that the minimum tax does not distinguish between holes in the tax system and real business losses.

**Tax paid by entities**

59. Individuals can hold investment assets in trusts and companies. The system is designed so that tax is paid by the entity on behalf of the individual shareholders. This tax would need to be taken into account in determining the amount of income tax to be offset against the minimum tax and vice versa. This issue is particularly relevant for closely-held companies, but also exists for investments in listed companies. If dividends were paid, some adjustment could be made for imputation credits, but if earnings were taxed in the company, but not distributed, double taxation would result.

**Link to capital gains taxation**

60. A more targeted version of this idea could be explored as a supplement to a realisation-based capital gains tax. The advantage of this approach is it reduces the deferral and “lock-in” effect of a capital gains tax. The idea would be to apply the tax to investments that give rise to capital gains that will be taxed only upon realisation. Any excess credit would be refundable when the asset is sold (or the amount taxed could be added to the cost base of the assets), so it no longer operates as a minimum tax, but just to reduce the deferral of tax and lock-in on investments subject to a capital gains tax. This idea will be explored in the more detailed paper on capital gains taxations being prepared for the Group.

**Māori land**

61. Māori land is governed by Te Ture Whenua Māori Act 1993 (TTWMA). TTWMA recognises Māori land as taonga tuku iho and endeavours to balance the retention of land while facilitating the occupation, development and utilisation of that land for whānau and hapū. The average Māori land block is 52 hectares with 100 owners. The characteristics of Māori land mean the land may sometimes not be used in a way which provides much income to fund a wealth tax, and the land

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6 Māori land is defined in TTWMA as being Māori customary land or Māori freehold land.
may be difficult or sometimes impossible to alienate. This means that if a wealth tax were to apply to Māori land, it may be particularly difficult for the owners to fund the wealth tax. It also raises questions of who owns the land for wealth tax purposes, and whether a wealth tax should apply to Māori land.

Summary

62. The preliminary conclusions of the OECD work is that an annual net wealth tax is not needed as a mechanism for addressing inequality (as it has the disadvantages of adding a novel tax base to most tax regimes and it is more difficult to apply than an income tax) if there is a comprehensive capital income tax including a capital gains tax and an inheritance tax. The OECD also says a net wealth tax may be desirable if a country does not have an inheritance tax, although it notes that an annual net wealth tax with a low rate results in a much higher effective tax rate on capital than an inheritance tax at a higher rate.

63. In 2001, the McLeod Tax Review did not support implementing a general wealth tax in New Zealand, on the basis that ‘in a modern society income or expenditure are more appropriate and more effectively applied bases for taxing according to ability to pay’. They also noted that a general wealth tax, even at a low rate, would significantly raise the effective rate of taxation of income from capital. The review did, however, determine that there can be a case for a selective wealth tax if there was a gap in the income or expenditure tax base that a wealth tax could fill (Tax Review 2001).

64. While the overall impact of capital income tax and a wealth tax are similar, there are a number differences which should be considered in deciding if a wealth tax should apply in addition to a capital income tax. The following table summarises some differences between them:

**Capital income taxation and wealth taxation comparison**

**Fairness / social capital implications**

<table>
<thead>
<tr>
<th>Fairness / social capital implication</th>
<th>Capital income tax</th>
<th>Net wealth tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reduces inequality by slowing the accumulation of wealth by high income/high wealth households</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Taxes wealth that produces “invisible income” such as imputed rental income.</td>
<td>No</td>
<td>No(^7)</td>
</tr>
</tbody>
</table>

\(^7\) Assumes a net wealth tax would not apply to owner-occupied housing. However, if it did then a wealth tax would tax such income.
Taxes wealth that accretes at a faster rate more than wealth that accretes at a slower rate. | Yes | No.
---|---|---
Provides income “horizontal equity” (taxing the same amount of income at the same rate) among different income sources. | Yes | No.
Provides wealth “horizontal equity” (taxing the same amount of wealth at the same rate) among different forms of wealth | No | Yes

**Efficiency / financial and physical capital**

<table>
<thead>
<tr>
<th>Efficiency implications</th>
<th>Capital income tax</th>
<th>Net wealth tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Does not distort decisions on <em>how much</em> to save and invest.</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Does not distort decision on <em>what to invest in.</em></td>
<td>No</td>
<td>No³</td>
</tr>
<tr>
<td>Taxes economic rents more than marginal returns</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**Compliance and administrative implications**

<table>
<thead>
<tr>
<th>Compliance / administration implication</th>
<th>Capital income tax</th>
<th>Net wealth tax</th>
</tr>
</thead>
<tbody>
<tr>
<td>Consistent with current tax frameworks, so can build on existing compliance and administrative systems</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Third party reporting available, supporting compliance and administration and reducing opportunities for evasion.</td>
<td>Yes</td>
<td>No⁹</td>
</tr>
<tr>
<td>Tax liability realised only when cash flows available to fund it.</td>
<td>Yes¹⁰</td>
<td>No</td>
</tr>
<tr>
<td>As most other countries have a similar tax base, the tax cannot be easily avoided by changing residence.</td>
<td>Yes</td>
<td>No</td>
</tr>
</tbody>
</table>

**Questions for the working group**

- Does the Group consider that capital income taxation (with a potentially broader base) is adequate for the taxation of capital?
- Is the direct taxation of wealth tax a desirable additional mechanism?

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³ As illustrated in appendix 6, net wealth taxes apply at different rates to different types of assets, so are likely to be distortionary in practice. In theory, if they applied to all investment assets at a uniform rate, they would not distort decisions on what to invest in.

⁹ Additional reporting requirements could be added to support a net wealth tax, but experience of other countries have been that these have not been as comprehensive as those supporting income tax, so taxpayers have to engage in more effort of self-assessment (such as obtaining valuations) compared to an income tax.

¹⁰ Assumes a capital gains tax applies on a realisation basis. There could be some differences between taxation on accrual and cash flows in some regimes, such as financial arrangements (debt instruments), but these normally result in small differences between cash flow and tax liabilities arising in most cases.
4. Specific issues

65. There are two areas where New Zealand is notable for taxing capital income in a different way than other countries – capital gains and retirement savings. These will be discussed more fully in other papers but the following briefly describes the issues.

Capital gains

66. New Zealand does not have a general capital gains tax. However, it does have a number of targeted rules that tax capital gains in circumstances when the sale appears to be part of a business activity or when the property sold was purchased with the intent of selling it. However, most capital gains arising from selling real property, shares, businesses and intellectual property are not taxed.

67. Most OECD countries have a general capital gains tax. Many countries tax capital gains at concessionary tax rates.

68. In principle, a capital gains tax on accruing capital gains would be consistent with the BBLR framework and would be efficient. In practice, any capital gains tax is likely to apply only on realisation - when asset are sold. However taxing gains on realisation is still likely to be more neutral in its treatment of appreciating assets than leaving these gains completely exempt from taxation.

69. In practice, all countries tax capital gains on a realisation basis, as an accrual regime poses difficult valuation issues and also cash flow hardships as the tax is due before the property is sold. Applying the gain on realisation reduces the effective tax rate because the tax is deferred. For example, if the discount rate is 5% and property is sold at the end of the fifth year, the effective tax rate would be 77% of the statutory rate. A realisation basis may cause behavioural distortions (“lock-in”, the tendency of a capital gains tax to encourage taxpayers to defer sales of property in order to defer the tax liability). As a result, many capital gains tax regimes have rules that target situations where deferral is likely to be particularly inefficient and have exemptions or deferral of tax for these. As a result, capital gains taxes can be complicated to design and operate.

70. In addition capital gains and losses are often ring-fenced and this can potentially discourage risk taking.

71. Distributional data from countries with a capital gains tax, such as Australia and the United States, show the distribution of taxable capital gain income is highly

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11 Australia, Austria, Canada, Chile, Estonia, Finland, Greece, Hungary, Iceland, Ireland, Israel, Luxembourg, Mexico, Norway, Portugal, South Africa, Spain, Sweden, UK, USA
skewed to the wealthiest households, so not taxing capital gains raises fairness concerns.

72. Taxing capital gains can indirectly tax labour in some cases. For example, take the case of house owners who refurbish a house and sell it for a large gain. While that is legally a capital gain, in substance it is labour income. Under current rules that labour income is not taxed in most cases. A comprehensive capital gains tax would tax it.\textsuperscript{12} Another example is an entrepreneur who builds up their own business and sells it for a gain.

73. There are many design issues to consider in developing a capital gains tax. Some of these are in Appendix E (taken from the background submissions paper) and will be discussed in a later paper. One issue is whether the capital gains tax applies as gains accrue, or when realised (when the property is sold).

74. These and other design issues will be discussed further in a later paper.

**Retirement Savings**

75. New Zealand is one of the only developed countries that does not have a highly concessional expenditure tax regime for retirement savings. New Zealand also has low national savings rates and in particular private savings rates compared to most OECD countries.

\textsuperscript{12} Unless the house was the taxpayer's residence.
Figure 3 – Net National Saving and Investment

Source: Statistics New Zealand

Figure 4 – National gross savings rates

Source: OECD. Note: Statistics New Zealand data shows that New Zealand’s gross national saving has held steady at 20% of GDP in 2015/16.
Some commentators have questioned whether the lack of a concessionary retirement savings regime could be responsible for New Zealand’s low private savings rate and the preference for savers to invest in housing which can have lighter tax treatment than investing in financial assets (Coleman 2017).

New Zealand has some minor concessions for taxing managed funds such as the Portfolio Investment Entity, or PIE, regime which has a maximum tax rate of 28% while the maximum personal tax rate is 33%. For retirement savings, KiwiSaver has a member tax credit of 50 cents per dollar to encourage contributions, but it is capped at a low amount (at $521 on the first $1042 of annual contributions).

Almost all OECD countries except New Zealand have concessionary tax regimes for retirement savings. Most are EET (Exempt-Exempt-Taxed – the contribution is made out of income which is not taxed, the investment income is not taxed as it is earned, and the withdrawal of the capital and accumulated earnings are taxed when withdrawn) or a variation (such as a low tax rate at some points instead of exempt). Countries offering expenditure tax treatment for savings invested in preferential funds usually impose a cap on the maximum allowable annual contributions.
79. Reasons given by other countries for this treatment is to encourage higher savings rates and allow for a faster build up of retirement savings. Another reason given is to tax savings in financial assets comparably to owner-occupied housing in order to encourage more saving in financial instruments instead of housing. (Coleman 2017). These issues will be discussed in a later paper.

**Amount of private savings**

80. Taxing capital income (the middle “T” in TTE) in theory may cause people to consume more quickly (save less) than the counterfactual of not taxing capital income because the tax on the income reduces the return on savings. This should reduce the benefit of deferring consumption and therefore the incentive to save.

81. So reducing or removing the tax on capital income could cause people to save more. However, reducing taxes in general has an income effect. As people see their wealth increase more quickly because capital income is not being taxed, this may allow them to increase their current consumption as well as their future consumption. In other words they may reduce their savings.

82. There have been many empirical studies on whether reducing the tax on savings results in higher levels of private savings. There is no consensus on the extent to which these schemes promote private savings. But the reduction in government savings (from reducing tax revenue) mean that the schemes are likely to reduce national savings. Any increase in private savings in working life is likely to be balanced by greater dissavings later in life while the tax costs of the schemes is likely to produce an ongoing reduction in government savings.

83. An EET for retirement savings is likely to come with a substantial fiscal cost and add to longer term fiscal pressures. As suggested by the distribution of wealth information, high wealth households benefit most from this policy. We will be reporting to you further on this option in a later session.

**Investing in housing**

84. The idea that concessionary treatment for saving in financial assets would encourage saving in that form and less in housing is not as well tested. While savers would certainly prefer to use such accounts if they were available, the first substitution of form of savings is likely to be from shifting financial assets already held by savers into such accounts, since those savers have already shown a preference for financial assets.

85. Because a preferred retirements savings regime would almost certainly be capped with maximum contributions to manage the fiscal cost, there would be new boundaries introduced as some assets would necessarily be owned outside of the

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13 Although recent data suggests New Zealand savings patterns in housing and other assets are similar to other countries.
concessionary regime. So while the difference in treatment between investing and housing and investing in financial assets may be reduced in some cases, new boundaries would be created.

86. As discussed in chapter 3, reducing the tax on savings is likely to increase wealth inequality compared to the current settings.

**Inflation**

87. Inflation causes some distortions in the tax system. The tax system taxes nominal income, and since nominal income is usually more than real income, this could cause some investments to have a higher effective tax rate when measured against the real income they generate. An obvious example of this is for capital gains, and this has been used as a justification for some countries to have a lower tax rate on capital gain. However, the effect of inflation is pervasive and affects different forms of investment differently.

88. Inflation is the reason a bank account is shown to have the highest effective tax rate in figure 1. Although inflation is currently low, it can be a large component of an interest return when interest rates are low. Inflation has other impacts such as increasing the real value of interest expense deductions and it also affects returns from trading stock and depreciation calculations. Given the complexity of adjusting for inflation in the tax system, tax systems generally make no adjustment, except sometimes for capital gains taxes in an ad hoc way (through the tax rate).

**Note for the Group**

89. The Secretariat intends to provide further information for the Group on capital gains for discussion at a later session. This includes lock-in (theory and evidence) and ways of addressing it (rollovers, lower rates), inflation compensation (accurate or proxies, such as lower rates), loss ringfencing (efficiency issues and ways of addressing) and other design issues.

**Questions for the Group**

- Does the Group want more information on taxation of retirement savings or the impact of inflation on taxing capital income?
4. Conclusion

Summary of analysis

90. New Zealand has a system of taxing capital income described as TTE (the income that is the source of the capital investment is taxed, the investment income is taxed as it is earned, and amounts withdrawn from the investment are not taxed). This has fairness advantages in taxing different forms of income comparably, but it does have some inefficiencies in terms of distorting decisions to save and distorting decisions of what to invest in. Most forms of capital income are taxed, however there are some gaps, such as capital gains. An expenditure tax, which does not tax the middle “T” (taxing capital income as it is earned) is less distorting than an income tax. However, it does not raise as much revenue at a given tax rate as an income tax, and so other taxes would have to apply to replace the revenue, and those would have their own distortions. New Zealand has an indirect expenditure tax as GST, as well as a capital income tax.

91. Capital income tax has an effect of reducing inequality by reducing the rate of wealth accumulation of reinvested capital income. This effect could be strengthened by making capital income tax more comprehensive by taxing capital gains. An annual wealth tax would also have an effect of reducing inequality, as it would also reduce the rate of wealth accumulation by households. However, wealth taxes also have inefficiencies when applied in addition to an income tax, and have practical complications of defining what form of wealth to tax, how to value it, and considering whether it could encourage some wealthy households to emigrate to avoid the tax. Wealth taxes are not common internationally and countries that have had them have been removing them. It is a question for the Group to consider the extent to which taxes should be used as an instrument to reduce wealth inequality, and whether adding a wealth tax is the best way to do this especially since improvements in the income tax could also do this.

92. New Zealand’s system of taxing capital income differs from most OECD countries in two respects. New Zealand does not have a general capital gains tax, and it does not have a generous expenditure tax system for retirement savings. The Group is asked to note that more information will be provided on a capital gains tax for a future session. It is also asked if it would like more information on the taxation of retirement savings in the context of adequacy of savings or distortions to savings decisions. The Group is also invited to ask if it would like information on the impact of inflation on taxing capital income and ways to address it.
Appendix A: How New Zealand taxes particular forms of capital income

1. The following describes briefly how different investments made by New Zealand residents are taxed.

**Interest**

2. Interest earned by an individual is taxed at their marginal tax rate.

3. Inflation also affects the real effective tax rate, especially if inflation is high or interest rates are low. If you use the assumptions that underlie the EMTRs illustrated in Figure 1, the nominal interest rate is 5% and inflation is 2% (so the real interest rate is 3%). A 33% tax would apply to the nominal interest rate of 5% resulting in tax of 1.65 on a return of 5. But the real return was 3 and a tax of 1.65 on a return of 3 results in an effective tax rate of 55% on the real interest income.

4. Inflation affects other components of the tax base as well; interest expense as well as income, trading stock calculations, and depreciation deductions. The United States Treasury considered proposing inflation adjustments in the tax base in the early 1980s and New Zealand raised it in a discussion document in the late 1980s. The proposals were not pursued due to their complexity and a more benign inflation environment. Israel did have comprehensive inflation adjustments when their inflation rate exceeded 100% but has since dropped it.

5. The taxation of interest can be described as TTE.

**New Zealand Companies**

6. Investment in a domestic company is first subject to the company tax at 28% as the company earns income. Distributed income is subject to tax at the shareholder’s marginal tax rate, with an imputation credit for the company tax paid on the income. The result is the company tax ends up being taxed at each shareholder’s marginal tax rate. The tax treatment is TTE.\(^{14}\)

**Foreign Companies**

7. Investment in foreign companies is subject to a special tax regime called the fair dividend rate (FDR). Unlike investment in a domestic company, we are unable to tax foreign company income directly, and most foreign companies tend to have a low dividend payout rate, so relying on dividend tax alone is not an accurate approximation of how much the New Zealand shareholder is earning from investing the company. Instead we attribute a return of 5% on the opening value.

\(^{14}\) In some cases the company could earn income that is not fully taxed, such as land that appreciates. This means that tax on a company with those characteristics would have a lower effective tax rate. But the general scheme for taxing investment in a company is TTE.
of the investor’s shares as a proxy for a tax on the underlying company income. The tax treatment is TTE.

Owner-Operated Business

8. New Zealand has a high level of investment in owner-operated businesses (including farms) compared to most developed countries so it would be an omission not to include this as a possible investment of savings. The business could be owned directly or through a company (either a taxable company or an attributing look-through company). The business income is taxed as it is earned. A distinguishing feature is closely-held businesses are often operated informally where the owner’s labour income is not accurately separated from their capital income. This is not a problem in the current tax system since labour income and capital income are taxed at the same rate, but it could become an issue if capital income were to be taxed at a different rate. The tax treatment is described as TTE.

9. Note that owner-operated businesses may also appreciate in value so there could be components of income to the owner that are not fully taxed in such cases.

Investor Housing

10. Investor housing has received a lot of attention as a tax-favoured investment. Housing is not explicitly favoured by the Income Tax Act, but it benefits from the general lack of taxation of capital gains. While rents are taxed, capital gain is not taxed in most cases. In recent years there has been a high level of capital appreciation of housing. The tax treatment of investor housing could be described as TtE, with the small t representing a low tax rate since rents are taxed but capital gains are not taxed.

Owner-Occupied Housing

11. Owner-occupied housing is tax favoured but in a way which is not understood by many home owners. As with investor housing, capital gains are generally not taxed, but imputed rental income is also not taxed. This is the benefit an owner-occupier gets from being able to consume housing services without paying rent. If the owner-occupier instead rented the house, the rental income would be taxable; and the rent the owner would pay for living in another person’s house would not be deductible. By living in one’s own house, the tax wedge is removed.15

12. Non-taxation of imputed rents in common internationally because the concept of imputed rental income is not intuitive to the public. However, a few European countries do tax imputed rental income of owner-occupiers.16

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15 Non-taxation of imputed income is common, for example, driving your own car instead of renting a car. Imputed rent of owner-occupied housing is singled out as a potential distortion because it is material in size compared to other cases of imputed income.

16 Iceland, Luxembourg, the Netherlands, Slovenia and Switzerland.
The tax treatment of owner-occupied housing is TEE.

**PIE and KiwiSaver**

13. PIE (Portfolio Investment Entity) and KiwiSaver are special regimes for taxing investments. PIE investments are usually managed funds although there is also a company regime. Because of the nature of the entity, a PIE managed fund could generally hold only financial assets (debt instruments and shares) not including a significant (greater than 20%) interest in a company. The tax regime on the investments is generally as described above, but the regime makes it clear that capital gains from selling shares are not taxable, and the maximum tax rate (even for a 33% investor) is 28%. The company PIE regime is sometimes used for companies that own commercial real estate. The general PIE regime does not require the funds to be locked in, unlike KiwiSaver.

14. KiwiSaver is available only for investments that are locked in until the investor reaches the age of eligibility for superannuation (65). Because these are managed funds, a KiwiSaver fund could generally hold only financial assets. Income is taxed as described for the PIE regime. In addition, the government provides an incentive for contributions by contributing $.50 for every dollar contributed by the participant, up to a $521 matching amount. In addition to the government incentive, employers are required to match their employee contributions up to 3% of salary.

**Data on Amounts and Taxation of Household Investments**

15. The following table summarises the investments of New Zealand households by the amount invested and tax treatment as of 30 September 2017:17

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17 Reserve Bank of New Zealand Series C22 Household Balance Sheet. Data from the series was grouped into the above categories. Data and method limitations mean this information probably does not capture all of household investments, but it is a reasonably comprehensive source. The table does not show unallocated liabilities of $32 billion which is needed to reconcile with net wealth.
<table>
<thead>
<tr>
<th>Financial Assets</th>
<th>Cash and Deposits</th>
<th>Debt Securities</th>
<th>Domestic Shares (listed companies)</th>
<th>Foreign Shares</th>
<th>Investment Funds</th>
<th>Super Funds</th>
<th>Financial Assets subtotal</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount NZ$ Billions</td>
<td>$170</td>
<td>$5</td>
<td>$121</td>
<td>$8</td>
<td>$62</td>
<td>$95</td>
<td>$460</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>10%</td>
<td>0%</td>
<td>7%</td>
<td>0%</td>
<td>4%</td>
<td>6%</td>
<td>27%</td>
</tr>
<tr>
<td>Allocated Liabilities</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
<td>$0</td>
</tr>
<tr>
<td>Net Amount NZ$ Billions</td>
<td>$170</td>
<td>$5</td>
<td>$121</td>
<td>$8</td>
<td>$62</td>
<td>$95</td>
<td>$460</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>12%</td>
<td>0%</td>
<td>8%</td>
<td>1%</td>
<td>4%</td>
<td>6%</td>
<td>31%</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>TTE</td>
<td>TTE</td>
<td>TTE</td>
<td>TTE</td>
<td>TTE (PIE)</td>
<td>TTE (some KiwiSaver)</td>
<td>TTE</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Other Investments</th>
<th>Owner-Operated Business</th>
<th>Investor Housing</th>
<th>Owner-Occupied Housing</th>
<th>Other Investments Subtotal</th>
<th>Total Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amount NZ$ Billions</td>
<td>$201</td>
<td>$265</td>
<td>$786</td>
<td>$1,253</td>
<td>$1,712</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>12%</td>
<td>15%</td>
<td>46%</td>
<td>73%</td>
<td>100%</td>
</tr>
<tr>
<td>Allocated Liabilities</td>
<td>$0</td>
<td>$68</td>
<td>$173</td>
<td>$241</td>
<td>$241</td>
</tr>
<tr>
<td>Net Amount NZ$ Billions</td>
<td>$201</td>
<td>$197</td>
<td>$614</td>
<td>$1,012</td>
<td>$1,472</td>
</tr>
<tr>
<td>% of Total Investments</td>
<td>14%</td>
<td>13%</td>
<td>42%</td>
<td>69%</td>
<td>100%</td>
</tr>
<tr>
<td>Tax Treatment</td>
<td>TTE</td>
<td>TtE</td>
<td>TEE</td>
<td>Mixed</td>
<td>Mixed</td>
</tr>
</tbody>
</table>
## Appendix B: How an expenditure tax differs from an income tax regarding capital income and savings

1. **GST**, an indirect expenditure tax, can be viewed as an indirect tax on income from labour together with a lump-sum tax on wealth on the day that the tax is introduced.

   To see why the GST is an indirect tax on labour income, consider an individual who earns $100 in year 1. If there were a 20% tax on all income or on labour income only, the individual would pay $20 in tax and could consume $80 in that year.

   Likewise, if instead there were a GST of 20% of the tax-inclusive price, the individual could spend $100 in year 1 on consumption in which case $20 would go to the government as GST revenue leaving the individual able to enjoy $80 of real consumption goods. Whether there is a tax on all income, on labour income only or on consumption, the taxes reduce the return from labour by 20%.

2. In addition to the tax on labour income, the GST also imposes a tax on any wealth at the time the tax is introduced, as whenever the wealth (together with any accumulated interest) is spent, it will be taxed.

3. **GST** is not a tax on savings generally.

### Consider the case where rather than spending the income immediately, an individual chooses to save any after-tax income and spend this in year 2.

Suppose that there is an interest rate of 10 percent. Under a labour income tax, the individual would pay $20 of tax in year 1 on the earnings and could save $80. This would generate interest income of $8 and allow consumption of $88 in year 2. (Note that if only labour income were taxed, there would be no tax on the $8 of interest income in year 2). Under a tax on all income, the individual would once more pay $20 of tax in year 1 and save $80. But in this case the interest of $8 earned in year 2 would be taxed leaving $86.40 available for consumption in year 2.

Under a GST, the individual would pay no tax in year 1 and could save $100. In this case $10 of interest would be earned in year 2, leaving $110 available for consumption in this year. However, in this case $22 would be paid in GST leaving only $88 of real consumption goods to be purchased in year 2.

Like a tax on labour income, the GST allows the individual to consume $80 of real consumption goods in year 1 or $88 of real consumption goods in year 2. By contrast a general income tax allows the individual to consume $80 of real consumption goods in year 1 or $86.40 of real consumption goods in year 2. Under either a labour income tax or a GST the benefits of forgoing consumption are the 10 percent pre-tax interest rate (forgoing $80 of consumption in year 1 leads to $88 of consumption in year 2). By contrast under a general income tax the benefits of forgoing consumption are the 8 percent after-tax interest rate (forgoing $80 of consumption in year 1 leads to $86.40 of consumption in year 2).

Like a tax on labour income only, the GST drives no wedge between the pre-tax and the post-tax return to saving. By contrast, with a general income tax the after-tax interest rate is less than the pre-tax interest rate.
4. GST has the same efficiency benefits as an expenditure tax which has the same benefit of treating consumption now and consumption later (savings) the same on an NPV basis\textsuperscript{18}. As a result it does not impact investment decisions.

\textsuperscript{18} This is assuming that the rate of return is equal to the discount rate. If the rate of return is higher (economic rents), then the NPV of deferred consumption would be higher.
## Appendix C: Comparison of wealth taxation

<table>
<thead>
<tr>
<th>Application</th>
<th>Exemption</th>
<th>Rate</th>
</tr>
</thead>
</table>
| **Argentina** | Deposits in Argentine institutions are exempted from the tax base. In addition, the personal asset tax exemption now applies with respect to:  
- Securities, bonds, and other negotiable instruments issued by the National, Provincial and Municipal Governments and the City of Buenos Aires, irrespective of the date of acquisition  
- Certificates of deposits previously subject to the freeze on bank accounts and currently rescheduled and replaced by “CEDROS” bonds | 0.25% on net wealth over ARS 1.05 million<sup>21</sup> |
| **Italy** | For bank accounts held in EU/EEA states the tax rate is substituted by a flat rate charge of EUR 34.20 per account. If the annual average in a bank account is less than EUR 5,000, the wealth tax is not charged. Certain personal items (such as art, yachts, luxury vehicles, precious metals and jewelry) held abroad by an Italian tax resident do not attract a wealth tax, but they are subject to reporting requirements under Italy’s fiscal monitoring rules. | 0.2% |

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<sup>20</sup> [https://www.angloinfo.com/how-to/argentina/money/income-tax/wealth-tax](https://www.angloinfo.com/how-to/argentina/money/income-tax/wealth-tax)

<sup>21</sup> ARS 1.05 million converts to approximately $NZD73,000 (22 February 2018).

### Application

| Norway | An individual resident in Norway for tax purposes on 1 January in the year following the income year is subject to net wealth tax on his/her worldwide wealth. Non-resident individuals are only subject to wealth tax on certain property in Norway, generally on real estate and on assets connected to a permanent establishment or fixed place of business in Norway.|

### Exemption

| While not an exemption per se, real estate has a somewhat ‘lighter’ tax treatment than other forms of wealth. For tax purposes the value of real estate assets are estimated to approximately 50% of the market value (25% if it’s the taxpayer’s primary residence). The following assets are exempt from wealth tax: |
| - Household contents (excluding jewels, fur coats, vehicles, boats, art, and antiques)  
- Pension rights  
- Owner-managed small businesses  
- Family companies meeting certain conditions  
- Shares in property investment companies where the company carries on a commercial activity  
- Intellectual property rights in the author’s ownership  
- Business assets (to qualify the activity must be the taxpayer’s main source of income and be carried out by the taxpayer on his own account and on a habitual basis). |

### Rate

| Municipal wealth tax: 0.7% of wealth above NOK 1.4 million  
| State wealth tax: 0.15% of net wealth above NOK 1.48 million. |

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26 NOK 1.4 million converts to approximately $NZD243, 000 (on 22 February 2018).
<table>
<thead>
<tr>
<th>Application</th>
<th>Exemption</th>
<th>Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Spain</td>
<td>Wealth tax is payable on the value of your assets on the 31 December each year. The wealth tax applies to those with wealth more than €700,000, at the rate of 0.2 – 2.5% depending on region. Wealth tax is payable on the value of most assets, including real estate, savings and investments, jewelry, art, cars and boats.</td>
<td>The wealth tax is not levied in Madrid. In general, each resident individual has a tax free allowance of €700,000 plus a €300,000 allowance on the value of his main home. If a couple owns the property in joint names, each gets the €300,000 allowance. Non-residents receive the individual allowance of €700,000, but no allowance against their Spanish property (note that this allowance can vary in some regions).</td>
</tr>
<tr>
<td>Switzerland</td>
<td>All cantons levy a net wealth tax based on the balance of the worldwide gross assets minus debts. Some cantons may allow additional social deductions. Reportable assets are as follows: - Bank account balances, bonds, shares, funds and other equities. - Life insurances with a surrender value. - Cars, boats, airplanes, etc. - Properties/real estate. - Other valuable assets, e.g. paintings, art collections, jewelry, etc. Household goods and leased assets are not subject to wealth taxation.</td>
<td>Rates are variable on region, wealth thresholds and whether the taxpayers are single or filing jointly</td>
</tr>
</tbody>
</table>

Movements away from wealth taxation

27 [http://taxsummaries.pwc.com/ID/Switzerland-Individual-Other-taxes](http://taxsummaries.pwc.com/ID/Switzerland-Individual-Other-taxes)
For those countries that still apply wealth taxation, many are seeking to move away from it, often citing concerns that it was driving wealthier residents away from the country.

Of the OECD countries, **France** has made the most recent movements to reduce wealth taxation. On 1 January 2018, France abolished its wealth tax (which was assessed on all assets owned by the taxpayer when net wealth is above €1.3 million) and replaced it with a real estate wealth tax (which, as the title suggests only applies to taxpayers who have real estate wealth above €1.3 million)\(^28\).

**Spain** abolished the wealth tax from the 2008 financial year, following years of sustained economic growth in the years prior. By 2011, however, the global financial crisis and the lack of funds of the Spanish Inland Revenue triggered Spain’s reactivation of the wealth tax. Although the law at the time stated it would only apply in the 2011 and 2012 fiscal years, it has applied every year since, and it is not clear when it will be lifted again.

**Norway** currently has a wealth tax (as detailed in the table above), but political parties across the political continuum (e.g. the Conservative, Progress and the Liberal parties have all stated that they aim to reduce and eventually eliminate the wealth tax). **Argentina** has also indicated an intention to progressively lower the wealth tax over the next fiscal years.

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Appendix D: History of transfer taxation in New Zealand

Inheritance tax/estate duties

1. Death duties were first introduced in New Zealand in 1866 and, in the many decades since, the country has seen many forms of this type of taxation (for example, probate duty, legacy duty, succession duty and, finally, estate duty) (Littlewood, 2012).

2. While death duties were originally intended simply as a means to collect revenue, by the end of the 19th century, they were also viewed as a means of breaking up large fortunes and re-distributing wealth (ibid). Since 1949, however, the system of death duties (in their various forms) were gradually narrowed across a period of decades, and as ‘estate planning’ became more common and more sophisticated throughout the century, estate duty was producing little revenue by the second half of the 20th century (ibid). In 1993, death duties were finally abolished.

Gift duty

3. Gift duty was first introduced in New Zealand in 1885 to prevent people avoiding death duties by giving their property away, usually to their children or on trust for their children, who would inheritance the property anyway (Littlewood, 2012).

4. Although death duty was abolished in 1993, gift duties remained part of the tax system for another 18 years until their repeal in 2011. In 2001, the McLeod Tax Review recommended that gift duty should be repealed, on the basis that it involved significant compliance costs (despite raising only $1.6 million per year at that time) and that the rationale for such a tax had been eroded by other tax changes within the prior two decades. While the review acknowledge that gift duty did still, to a minor degree, protect the tax base, that other less expensive options should be considered (Tax Review, 2001). Despite its minimal contribution to tax revenue, however, it was considered that fiscal circumstances did not allow for gift duty to be repealed at that time (Inland Revenue, 2010).

5. Gift duty wasn’t removed until after a subsequent officials’ review in 2010, which also made the case to repeal gift duty. At the time of the review, Inland Revenue recommended that gift duty be repealed on the basis on enhanced efficiency, simplicity, reduced administrative costs and a significant reduction of private sector compliance costs (although acknowledged the fiscal cost as a relevant consideration) (ibid).
Appendix E – Design issues with a capital gains tax

- Should the CGT be a separate tax or part of the income tax? Most countries tax capital gains as part of the income tax.
- Should capital gains be taxed on an accrual basis or only when realised (i.e. only when the asset is sold)? Most countries tax on a realisation basis. How should matrimonial property settlements and disposal of assets on death be treated?
- What assets should be covered given that the terms of reference exclude any tax on the family home? Should it include just rental properties, shares, collectibles, private assets such as cars?
- Should assets held by KiwiSaver and other savings schemes be taxed?
- Should assets held offshore be subject to tax?
- How would a capital gains tax integrate with current tax laws, such as when land sales are already taxable, our company imputation system and our CFC/FDR rules?
- When should non-residents be subject to tax?
- Should capital losses be ring-fenced to be offset only against capital gains income or should they be offset against any income? If capital gains are taxed on a realisation basis tax base maintenance considerations suggest that capital losses should be ring-fenced.
- Should there be roll-over relief allowing capital gains re-invested in similar assets to be treated as unrealised? If so, when should roll-over relief apply? For example, should a farmer selling a farm and buying a new farm be taxed on the increase in value of the old farm?
- How should death, emigration and immigration be handled?
- How should gifts and gambling winnings be taxed?
- What should the rate of tax on capital gains be – the normal income tax rates, or some other rate(s)?
- Should any allowance be given for inflation in calculating capital gains?
- Should there be a de minimis rule?
- What administrative implications would there be from a capital gains tax?
- What rules should govern the transition into a capital gains tax? The options seem to be cost of the assets (retrospective taxation of past accrued gains), valuation at date of introduction or only assets acquired post introduction (the Australian rule).
- How should family trusts be integrated into the system?
References


