Tax Working Group Information Release

Release Document

September 2018

taxworkingroup.govt.nz/key-documents

This paper has been prepared by a member of the Tax Working Group for consideration by the whole Tax Working Group.

The advice represents the preliminary views of the member who prepared the paper and does not necessarily represent the views of the whole Group or the Government.

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Taxing Capital Income

Introduction

Craig Elliffe

Note: I have used quotes from international authorities and academic commentators in this brief introduction, some of these I would not express so strongly.

Extending our existing rules or comprehensive?

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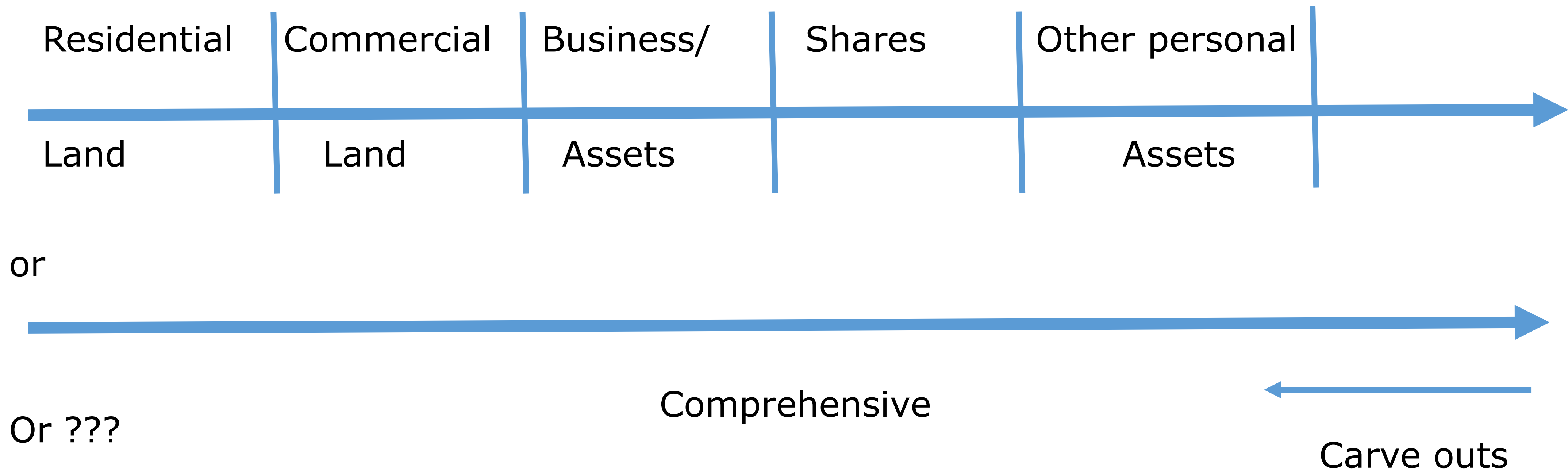
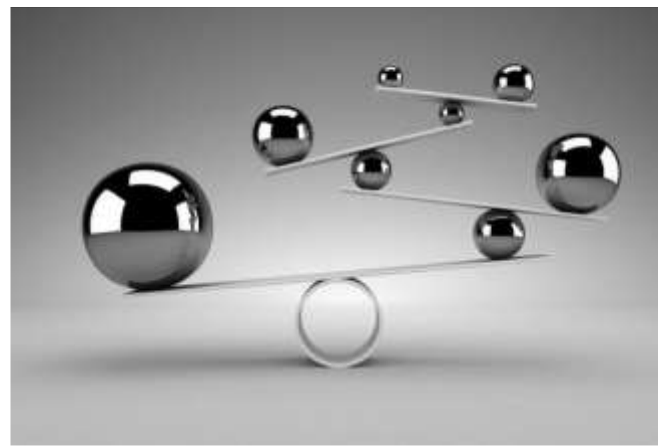
Extending the spectrum of asset classes



History



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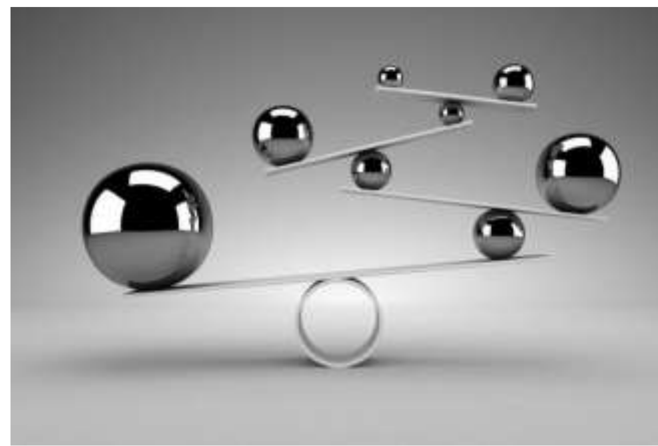
- **Previous NZ reviews**
  - Since 1951 we have been considering the case for introducing a comprehensive CGT in NZ
  - Often concluded there is a strong case for introductions but time was "not quite right" or strong practical grounds (usually involving either the measurement of the capital gain or administration of the tax)
  - According to Evans and Krever (2017) these reviews and reports have "steadfastly flown in the face" of international experience, the OECD, and most academic research.
- **Report of the OECD (2000)**
  - "There are a number of adverse consequences of *not* imposing a comprehensive tax on capital gains, especially since New Zealand applies an otherwise comprehensive income tax system: the income tax base is narrowed; the allocation of savings and investment is distorted; tax-shifting behaviour is encouraged, in particular among high-income earners and wealthy individuals; and a non-level playing field is created among different financial instruments."

History



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- **OECD's 2013 Economic Survey identified**
  - that New Zealand should "[i]mplement a capital gains tax and boost environmental and property or land taxes to facilitate a more efficient and equitable tax structure".
  - belongs to a group of five OECD countries with particularly high pre-tax capital-income inequality… As much of this income, especially at the top levels, takes the form of capital gains, the lack of a capital gains tax in New Zealand exacerbates inequality (by reducing the redistributive power of taxation). It also reinforces a bias toward speculative housing investments and undermines housing affordability.

International Perspective

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- After GST, CGT has been the most widely introduced tax in recent decades
- In 2001, when South Africa introduced its regime, CGT was in 114 countries.
- By 2017, 187 out of 220 countries or 85% of countries had a CGT

Note that some countries only tax realised gains made by business taxpayers

Table 1: Regimes for Taxing Capital Gains around the World (2017)[17]

Region	Number of countries taxing capital gains	Number of countries only taxing capital gains realised by business taxpayers	Number of countries not taxing capital gains, or where information is not available
Africa	48	4	1
Americas	33	2	15
Asia	40	5	6
Europe	38	5	4
Oceania	12	0	7
Total	171	16	33

Evans and Krever (2017) Taxing CGT: A Comparative Analysis and Lessons for NZ

Principles of assessment

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Essentially seen as a question of **fairness** or **equity**

- Horizontal (actual economic position(s) and perceptions)
- Examples may include unpaid labour and rents being converted into cgs (this could also be a vertical equity issue)

- Vertical more contentious because progressivity is a (more) political issue
- The top 20% of NZers have 82% of assets that generate CGT and overseas experience suggests 60% of reported capital gains came from 1% of returns (Canada), 0.4 % of returns (US), 0.1 % of returns (Burman and White(2003)).
- HWI experiences suggest that cgs are an important part of HWI profile

Principles of assessment

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- From the perspective of **Efficiency**
  - **Belief that distinctions in the tax system violates neutrality and causes economic distortion**
  - Examples are allocation of investments into less productive but tax preferred asset classes (property rather than businesses)
  - May be sectors that have a higher proportion of cgs to taxable income
  - How does this affect our savings performance and experience
  - Could discourage regular investment because of fear of being a trader and so affect investor behaviour

  - **Belief that taxing CG causes distortions by discouraging risk taking and means investors are locked in to investment position**
  - Examples are reduced investment and negative impact on economic growth
  - Discouraging entrepreneurship and risk-taking if you don't allow losses to be offset

Principles of assessment

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- **Revenue Integrity**
- System design issues
  - Deductions available at the time of incurring the expenditure (interest expense, expenditure on R&D, expenditure on developing intellectual property (not patents), expenditure on software) but gains substantially not taxed on realization
- Classification incentives
  - Allocation of business assets from taxable to non-taxable
  - Decision making on sale of shares and assets
  - Decision-making on intention/purpose tests
- Avoidance
  - Decision-making on intention/purpose tests
  - Dividend splitting
  - Sale of IP and lease back to NZ user (ex-owner)

Principles of assessment

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- **Fiscal Adequacy**
- Likely to be small-perhaps 1% of GDP or $2.7 billion
- Revenue flows difficult to predict
- Essential role is not to raise revenue but to act as a backstop to the income tax system and thus can be seen as an integrity measure. In this way it will add revenue to the existing income system

Principles of assessment

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- **Compliance and administration costs**
  - Likely to be significant, however policy could elect robust and simplified alternatives to "taxing the last dollar"
  - Some opportunity for reform which would simplify some tests. For example, would it still be necessary to retain the associated persons provisions in the land sales rules?
  - Would need to consider scope and potential for avoidance

Principles of assessment

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- **Coherence**
- The question we have to ask ourselves is whether this will improve our current system or not?
  - Burman and White, it is "an incoherent mix of taxation based on accruals, realisation, and imputed return, combined with a large class of exempt assets".
  - [T]he current hybrid set of New Zealand tax rules is far from ideal. For much of its life, the New Zealand income tax has taxed some appreciation in the value of property. Indeed, at least 25 kinds of assets and transactions are presently defined as taxable - some on realisation, others on accrual or an equivalent, and still others based on imputed return.

Principles of assessment

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- **Coherence**
- The question we have to ask ourselves is whether this will improve our current system or not?
  - Burman and White, … The result is a grab bag of income and deduction rules accumulated over more than 100 years. Some rules were developed by judges, often drawing on inappropriate trust law concepts. Others were hurried and unnecessarily complex responses by Parliament to economic events. And some were the result of more principled tax policy analysis and consultation by government. But even some of these latter provisions may not represent appropriate tax policy for a small, open economy in 2009 and in the medium-term.