Tax Working Group Information Release

Release Document

September 2018

taxworkinggroup.govt.nz/key-documents

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.

Inland Revenue
Te Tari Taake

Policy and Strategy
Te Wāhanga o te Rautaki me te Kaupapa
55 Featherston Street
PO Box 2198
Wellington 6140
New Zealand

T. 04-890 1500
F. 04-903 2413

Memorandum

12 June 2018

To: TWG Capital income taxation subgroup

From: Phil Whittington

Rollover relief

This note tries to pull together the various discussions that we have been having about rollover relief. Two tables at the end of this document can be used to try to record any consensus decisions at our upcoming meeting.

Overall principle

If the TWG decides that a capital gains tax is important for fairness and efficiency principles, it would seem that the default would be that it applies whenever a capital gain is realised. There is a special consideration regarding death, as in that case the gain itself has not been realised (in the sense that the asset has not been sold in exchange for cash or even another asset), but the person who had the capital gain has ceased to exist. It might be considered appropriate that at that point, the person's tax affairs are settled before any bequests are made. I come back to death later though, as it needs a much more thorough treatment and discussion.

If the overall principle is that a capital gains tax should apply when there are realised capital gains, then the discussion becomes about whether there are certain realisation events where it would be undesirable, for either fairness or efficiency reasons, to actually charge the tax. In those cases, rollover relief should be provided. If we pursue this route, we are not looking for some overall legal principle that justifies rollover relief, but rather accepting that although a capital gains tax may be desirable for fairness and efficiency reasons, there are tradeoffs in doing that, and we (like every other country with a capital gains tax) want to isolate what are (more or less limited) instances where it is not charged.

On the question of whether the instances of providing rollover relief should be more or less limited, the Secretariat is of the view that New Zealand has some historic success of more comprehensive and "pure" taxes (e.g. in particular our GST), and so it might be possible and desirable to err on the side of being more limited in rollover relief.

If the subgroup is of the view that the problems of a CGT are sufficient that rollover relief should be very extensive, that may reflect a view that a CGT which is actually able to be implemented is not worth having. If that's the case, it would seem to be better to have a debate on those grounds rather than ensuring the CGT only applied in fringe cases.

As an initial definitional matter, it might be helpful if we distinguish between rollover relief, and (true) exemption. Rollover relief means that where there would otherwise be a realisation event, the capital gains tax is deferred. For example, roll-over may occur:

- because a replacement asset is purchased. In this case the cost basis of the old asset is "rolled over" into the new asset;

- when an asset is transferred to an associate. In this case, the cost of the transferred asset carries over to the new owner regardless of what the new owner paid.

In both cases, if the cost basis of the new asset (in the first instance) or the old asset to the new owner (in the second instance) is "stepped up", this really means that there is an exemption of the gain from the tax permanently.

Rollover relief provides for deferral (rather than exemption) of recognition of part or all of assessable income in particular circumstances. It overrides the general presumption under a realisation-basis capital gains tax that realisation triggers an assessment of tax.

Situations that might require rollover relief

This note quickly works through the usual cases where rollover is considered, providing notes on the fairness and efficiency implications of charging a capital gains tax. Where the secretariat has a view I have included that view, and we can discuss in more detail in our upcoming meeting. Ultimately, the subgroup is reporting back to the Tax Working Group and has responsibility for the design of the CGT being proposed. The Secretariat will point out to the TWG if the secretariat has a different view. This is not intended to second guess the subgroup, but to discharge our obligation to the TWG to provide our best advice.

Compulsory acquisition

The secretariat is of the view that rollover relief should be provided when property has been compulsory acquired by a requirement of the State[1] to the extent that the disposing person acquires another capital asset within some time frame. This is because it seems unfair for the government to take advantage of a realisation event it has forced to occur to then charge tax on the gain. Provided the person whose property has been acquired invests in any other capital business asset within a specified timeframe (discussed below), it seems appropriate to provide rollover relief. The secretariat would suggest not requiring the person to invest in the same asset type (e.g. land if land was acquired), as this creates a different kind of asset-class specific lock-in.

Insurance (or other similar) proceeds

The secretariat is also of the view that charging capital gains tax for insurance proceeds where there has been a natural disaster, or fire, or other event (so long as it is not caused by the taxpayer), then rollover relief should be provided to the extent that the insurance (or other compensation proceeds) are reinvested in any business asset. It would be untenable in a natural disaster to charge capital gains tax on insurance proceeds where the property is only "disposed of" because it has been destroyed, through no fault of the taxpayer.

Same asset and ultimate economic owner

A further instance where rollover relief should be provided is when a taxpayer remains the ultimate economic owner of the same underlying assets but due to restructuring a capital gains tax liability would otherwise be triggered. There are two rationales for this. One is base protection. The concern is that a taxpayer does not sell an asset to an associated person primarily to crystalise a loss.

Furthermore, we would not want lock-in preventing a restructuring. Lock-in may be more significant in the case of restructuring, since the taxpayer doesn't want to alienate the asset, just to own it in a different way. It may hold off doing this in order to avoid tax if there was no roll-over relief.

An example would be where a sole trader decides to incorporate a company and put the business assets in the company. Because this will require selling the business assets to the

---

[1] Roll over relief would not apply, for example, where goods are sold under a power of sale held by a creditor.

company, a capital gains tax liability would be triggered if there had been a gain. In a case like this rollover relief seems sensible as otherwise the capital gains tax would prevent sensible business restructures that do not involve any fundamental underlying change in assets.

Asset-class specific rollover relief

An asset-class specific rollover means that if a business sells an asset and would be taxable on a capital gain, the gain can be deferred if and to the extent that the business buys a similar asset with the proceeds. If the new asset is sold, the difference between the sales proceeds and the cost base of the original asset is the capital gain (unless another rollover relief applies).

The primary benefit of rollover relief on an asset-class specific basis is the removal of lock-in. This is particularly salient when considering a small business that is growing and upgrading premises, in a situation where its current premises have increased in value. The crystallisation of the capital gains tax liability after the sale of current premises means that the post-tax sales proceeds (with which replacement premises will have to be funded) will often be materially lower. As a consequence, the small business will be discouraged, at the margin, from upgrading the premises.

The costs of an asset-specific rollover relief are that it:

- Creates a different kind of lock-in that relates to a specific asset class. In effect this is a disincentive to change the nature of one's business or diversify.
- Reduces the general fairness and efficiency benefits of a capital gains tax (while noting that it reduces the specific efficiency costs of lock-in to particular assets when a decision about purchasing a replacement or upgraded asset of the same class is being contemplated).
- Increases compliance and administration costs as taxpayer's have to nominate "replacement" assets within specified time periods.
- Creates a distortion because assets that lose value are not given "rollover" treatment (i.e. assets that lose value and are replaced are allowed deductions for capital losses).
- Is likely to require a strong distinction between "traders" and other owners of assets, as rollover should not be provided to traders.

One way of ameliorating the first problem identified above is by allowing rollover relief on demand – that is, so long as any other capital asset is purchased, rollover relief is provided. This idea has been raised already in discussions. The issue with this idea is that it exacerbates the second bullet point above. At the limit it may be better to simply not have a capital gains tax rather than allow rollover relief for all realisation events that do not result in consumption.

What do other countries do for active assets?

Australia provides a small business capital gains tax concession. If you sell an "active asset" (i.e. you use it or hold it ready for use in the course of carrying on a business) used in your small business, you can defer all or part of a capital gain for two years, or longer if you acquire a replacement asset or incur expenditure on making capital improvements to an existing asset. To qualify the small business must have aggregated annual turnover of less than $2 million AUD. This applies to farms, but as far as I can tell there is no general "farm replacement" rollover relief if you do not meet the small business test.

In the USA, rollover relief is provided for real property used in a business if replacement property is purchased[2], including farms. It does not apply to taxpayers who hold real estate as inventory or who purchase real estate for resale, as these taxpayers are considered "dealers".

In Canada, if real or immovable business property used primarily for the purposes of earning business income (not counting rental property) is disposed of and replacement property is

[2] The Tax Cuts and Jobs Act of 2017 greatly narrowed the amount of rollover relief provided: it only applies to real property now.

acquired, rollover relief is provided. That is, it generally applies to business premises, but not other assets. It includes farms.

In South Africa, there is no rollover relief for same asset-class replacements[3]. A farmer who sells a farm and replaces it with another farm would be taxed on any capital gain.

In essence the decision here is a judgement call about the relative costs and benefits. The Secretariat's view is that it would be best to have no asset-class specific rollover relief.

Rollover for inheritances and gifting

As noted above, rollover on death (in effect, rollover to heirs) is a distinct issue. In this case, there has been no actual realisation of the assets. The legal owner of the assets has died and in principle, their tax affairs should be settled. In the case of a realisation-based capital gains tax, they've had the advantage of deferral because of a realisation-based CGT. That advantage stops at death, and given we tax on an individual basis, it might seem appropriate to tax the gain they have accrued through their life time.

Some may view charging capital gains tax on death as a disincentive to wealth accumulation and bequests. However, this disincentive exists to the extent we tax any income from savings that will be passed to heirs. If we are concerned about the disincentive to bequests that the tax system creates, we should also be concerned about tax on interest income where that interest income will be passed to heirs. There does not seem to the secretariat to be a strong fairness or efficiency reason (putting aside operating businesses and illiquid assets discussed below) to single out capital gains income and allow it to flow untaxed to heirs. People whose parents earned interest income, or whose parents died with no unrealised capital gains do not receive that tax subsidy.

There is a special concern about the treatment of operating businesses and other illiquid assets on death. If assets were sold at a discount, or businesses were wound up because tax needed to be paid quickly, this would seem to be both unfair and inefficient. This supports a view that rollover relief for operating businesses and other illiquid assets should be provided. This then raises the question of whether it is important to be consistent with **all** capital gains tax on death. If it were, then rollover relief should perhaps be provided for all capital gains (including, for example, liquid portfolio shares). In the view of the secretariat, it is not the fact that the income was earned through capital gains that mean that concessionary treatment might be provided to heirs on death, but the illiquidity of the asset and the unfairness and inefficiency of requiring a sale or wind up of (for example) a business.

As a consequence of the above, the secretariat is of the view that rollover relief should be limited to bequests of operating businesses and illiquid assets (discussed in more detail below).

In addition, the secretariat considers that bequests to surviving spouses or partners (through marriage, civil union, or de facto relationship) of any assets be provided with rollover relief. This may be hard to square with our observation above that New Zealand taxes on an individual basis, but it reflects the reality that assets are generally held jointly by spouses and partners, and income from such is not as straightforward to allocate to individuals as labour income.

What are "illiquid assets"?

If the subgroup wants to make a distinction based on assets that are illiquid, a definition of that term will be required. The secretariat suggests the following classification:

Illiquid (qualifies for rollover relief)	Liquid (does not qualify for rollover relief)

[3] The South African CGT allows rollover relief where an asset is disposed by way of operation of law (for example, expropriation), theft, or destruction.

Privately-held operating business, including farms	Portfolio shares
Controlling stake in publically-listed company	Investment funds, including KiwiSaver
	Rental property

If transfers of certain assets, or to certain persons, on death is eligible for rollover relief, it is likely that gifts should also be treated as eligible for rollover relief on the same basis. Otherwise, an asset owner will be incentivised to hold long-lived assets until death to ensure that the transfer occurs that way, rather than through gifting.

Design considerations for rollover relief

If countries allow rollover relief, they tend to limit it to instances where it stays in the tax base. The two most important considerations here are that:

- if rollover relief is provided and a new asset is purchased, the new asset itself must be in the tax base.
- If the asset is owned by a new person (e.g. through rollover on death), rollover is not provided for transfers to non-residents or tax-favoured entities like charities.

On the first of these, the logic is explained by the South African Revenue Service[4]:

> The requirement to replace an asset with one from a South African source is designed, for example, to prevent a resident from replacing an asset with one attributable to a foreign permanent establishment, with the result that South Africa may lose its taxing rights over the asset under the relevant tax treaty. Alternatively, even if the asset does not form part of a foreign permanent establishment, it must not be subject to tax in a foreign country. Were it to be so subject to tax, South Africa would likely have to give credit for the foreign taxes under s [ref], thus eroding the South African tax base. The requirement also prevents a non-resident who would be subject to CGT on South African immovable property or assets effectively connected with a permanent establishment in South Africa under para [ref] from replacing such assets with non-taxable assets from a non-South African source.

The second consideration simply ensures that the rollover relief does not become a de facto exemption.

The other main issue is the time limit for finding and purchasing a replacement asset. 1 or 2 years seems to be a standard time, although the USA allows a maximum of 180 days.

Other issues include how to allocate capital gain over multiple replacement assets (South Africa's formula approach seems sensible), what to do with depreciation deductions that have been claimed (presumably claw them back, on the basis that that is the current treatment) and whether to charge interest on deferred capital gains if a taxpayer does not purchase a replacement asset within the time limit.

The secretariat suggests that given time constraints, the first two of these other issues (allocating capital gain over multiple replacement assets and what to do with depreciation deductions) are operational details that can be resolved through consultation after the interim report is released.

Note that if interest is not charged, taxpayers may indicate that they intend to purchase a replacement asset but never follow through, to delay the payment of the capital gains tax for the length of the replacement asset time limit.

Phil Whittington
Senior Policy Advisor

[4] P 509 of *Comprehensive Guide to Capital Gains Tax (Issue 6).*

Event	Rollover relief or not? (secretariat view)	Rollover relief or not? (subgroup view)	Notes
Compulsory acquisition by the state	Yes	Yes	Provided new asset is still in the tax base
Insurance or other proceeds	Yes	Yes	Provided new asset is still in the tax base
Same asset and ultimate economic owner	Yes	Yes	
Asset-class specific – active business premises	No	[No consensus as yet]	
Asset-class specific – all other assets	No	[Majority says no so far]	
All other reinvestment (i.e. not asset-class replacement)	No		
Death (surviving spouse or partner)	Yes		Unless surviving spouse is non-resident (if it is possible to have a non-resident spouse or partner)
Death (all other bequests)	Yes, for operating businesses and other illiquid assets		
Gifting	Yes, for operating businesses and other illiquid assets		

Design feature	Decision	Notes
Requirement that asset or new owner is in NZ tax base?		
Time period for reinvestment that qualifies for rollover		
Interest charged if reinvestment does not occur?		

Policy and Strategy
Te Wāhanga o te Rautaki me te Kaupapa
55 Featherston Street
PO Box 2198
Wellington 6140
New Zealand

T. 04-890 1500
F. 04-903 2413

Memorandum

21 June 2018

To: TWG Capital income taxation subgroup

From: Phil Whittington

Transition, valuation day, and the median rule

This note looks at how best to manage a transition to a capital gains tax in terms of the measurement of gains for assets purchased prior to the capital gains being in effect.

At the TWG Friday 4 May meeting there was some consensus that a "valuation day" was preferable to grandparenting existing assets. This would mean that all assets were valued on the day the capital gains tax came into force, and any gains or losses from that valuation would be subject to the capital gains tax. However, some members expressed concern with how it might work for hard-to-value assets, where there will be opportunities to overstate the value.

Median rule

The median rule was introduced in Canada when taxation of capital gains was introduced. The median rule has the effect of eliminating certain "paper" gains and losses that can arise with fluctuating assets values. This is likely to improve the perceived fairness of the transitional measures, for instance by ensuring that a taxpayer with an actual loss (i.e. sale price less than cost price) is not taxed, due to the valuation day value being lower than sale price. It also has the effect of limiting the scope for artificial loss creation through over-estimating the fair value of difficult-to-value assets.

Under the median rule the gain or loss subject to tax is

Gain or loss = sales price – X

In the above equation, X is the median of the cost price, the value on valuation day, or the sales price. The cost price includes subsequent capital expenditure, regardless of whether it happened prior to or after valuation day.

Perhaps surprisingly the system gives results that seem sensible when all the permutations are worked through. Consider values of $50, $80, and $100.

Smooth gain or loss

First let's assume that the cost price of an asset (prior to the capital gains tax being in force) is $50. Its value on valuation day is $80, and it is sold for $100. Under either a valuation day rule or a median rule, the gain will be $20. This is because the median of $100, $80, and $50, is $80. This is scenario A in the table below.

Scenario B is the mirror of Scenario A, with a smooth loss. In these cases the cost is the valuation day cost and so there is an identical treatment to valuation day. This is probably the pattern people have in mind when they suggest a valuation day.

Paper gain or loss

A paper gain or loss arises when prices do not follow a smooth path. There are two pairs of situations. In the first pair, situations C and D, prices rise (fall) until valuation day, and then reverse course until the asset is sold to partially offset the gain (loss). Under a valuation day approach, the taxpayer who made a gain overall would have a loss for tax purposes, and the overall loser would have a tax gain. The latter case would not seem fair to most taxpayers and symmetry means that if it is modified, the former case must also be modified. Under a median approach, the taxpayer would have no deductible loss or taxable gain. In other words, a post valuation day gain is ignored if the taxpayer has a loss overall, and a post vauation day loss is ignored if that taxpayer has a gain overall.

Situations E and F have even greater paper gains and losses. In this case, the original gains and losses are more than reversed. For example in Scenario E, there is a temporary loss of 30 that is more than recouped with a subsequent rise of 50 from valuation day. In that case the taxpayer would face tax on 50, when they had “only made” 20 compared to their original cost.

Overall, the elimination of “paper” gains and losses is likely to seem fair to taxpayers

	Smooth Gain or Loss		**Paper Gain or Loss**			
Scenario	**A**	**B**	**C**	**D**	**E**	**F**
Sales price	100	50	80	80	100	50
Valuation day	80	80	100	50	50	100
Cost price	50	100	50	100	80	80
Gain/(loss) (valuation day)	20	(30)	(20)	30	50	(50)
Gain/(loss) (median rule)	20	(30)	0	0	20	(30)
Treatment relative to valuation day	Identical	Identical	Less loss	Less gain	Less gain	Less loss

Limits on manipulation

At the TWG Friday 4 May meeting, some members were concerned about manipulation of valuation day for the purposes of reducing tax or increasing deductions. In short, for hard to value assets there is an incentive and opportunity to increase the valuation of valuation day. In the table below, the taxpayer overstates the value on valuation day, claiming that the value is is $200 to try to claim losses or limit gains.

Under the median rule the gains from this strategy are limited by the difference between the true valuation, and the higher of the cost price and the sales price.

	G	**H**	**I**	**J**	**K**	**L**
Sales price	100	100	80	80	50	50
Actual valuation day	80	50	100	50	100	80
Manipulated valuation day	200	200	200	200	200	200
Cost price	50	80	50	100	80	100
Gain/(loss) (true valuation day)	20	50	(20)	30	(50)	(30)

Gain/(loss) (manipulated valuation day)	(100)	(100)	(120)	(120)	(150)	(150)
Gain/(loss) (median rule)	0	0	0	(20)	(30)	(50)
Hidden income/overstated loss mitigated by using median rule	100	100	120	100	120	100

The final row shows the understated income or overstated loss that is countered by using the median rule.

Valuation methodology

There is still the question of how assets should be valued on valuation day, and whether valuation methods should be prescribed in statute or as a matter of administrative guidance. Obviously for assets like listed shares, the solution is the market value on valuation day (as discussed below, this could still be over-ridden by the median rule). For residential property a valuation based on local authority rating valuations may be appropriate. One method suggested for unlisted businesses and other hard-to-value assets is to assume a straight-line growth in value since the purchase of the asset (or, in the case of goodwill, initiation of the business).

Example

An entrepreneur formed a company with $50 000 of equity capital in 1999. The capital gains tax applies from 1 April 2019. The company is sold in 2024 for $8 000 000. There is $7.95m of capital gain over 25 years. That is $318 000 per year. The gain is treated as accruing evenly over the entire 25 years, so that the value of the shares on valuation day is $6 860 000[5]). Any gains from that time on are subject to the tax. Therefore, $1 140 000 is the gain on which tax is paid when sold[6].

The following table sets out what valuation methodology could be used for certain types of asset:

Asset	Methodology
Listed shares	Market value at valuation day (e.g. 5 day VWAP)
New Zealand residential property	Most recent valuation for local government rating purposes
Commercial property	Most recent valuation for local government rating purposes
Industrial property	Most recent valuation for local government rating purposes
Farm	Land and buildings, most recent valuation for local government rating purposes
Unlisted shares	Straight-line method
Closely-held company (could have a turnover threshold, above which independent valuations are possible)	Straight-line method
Goodwill	Straight-line method, unless there are insufficient records of either the original cost or any capital expenditure.
Any other asset	Straight-line method unless a liquid market

[5] $50 000 + 20 * $318 000

[6] A modified rule would have to be in place if there had been more than one contribution of capital at different dates. This note does not deal with that complication, but rules could be developed.

	for the asset exists, which should be used in preference

The Group will also need to decide whether these are optional or mandatory. or some combination of optional and mandatory at different market values (e.g. mandatory below a certain market value (e.g. $10m), and optional above it. If they are optional it is likely that they will act as minimums, with some taxpayers providing evidence of valuations above these values,

All assets or hard to value assets?

The remaining question is whether the median rule should be used for all assets, or only those assets that are difficult to value (e.g. businesses, unlisted shares etc.)

Some taxpayers may find themselves in a situation like scenario B for listed shares, but perhaps scenario C for hard-to-value assets. If we applied valuation day for scenario B, but the median rule for their hard-to-value assets (scenario C), they might feel that they got the worst of both worlds. If such a view limited public acceptance of the transition rules, it may be better to use a median rule for all assets.

Finally, it should be noted that it would be open to Inland Revenue to audit the valuation day valuation under either a valuation day rule or the median rule, if Inland Revenue was concerned it was misstated.

Options

The options for the group on the median rule are:
- Use a median rule for all assets, or
- Use a median rule for hard-to-value assets, or
- Do not use a median rule – use valuation day.

The options for the group for hard-to-value assets are:
- Use a straight line method for these assets to come to a valuation day figure, or
- Rely on self-reported valuations, or
- Some other method.

Finally, the group may want to suggest making some valuation methods mandatory or optional for certain assets, perhaps varying by value of the asset.

Phil Whittington
Senior Policy Advisor

Policy and Strategy
Te Wāhanga o te Rautaki me te Kaupapa
55 Featherston Street
PO Box 2198
Wellington 6140
New Zealand

T. 04-890 1500
F. 04-903 2413

Memorandum

11 May 2018

To: TWG Capital income taxation subgroup

From: David Holland

Inflation and capital gains

Introduction

This note responds to request to examine the possibility of having a reduced inclusion rate for capital gains on assets held for a sufficient time, say five years. Such provisions exist in a number of countries.

One rational for the provision is the same as New Zealand's brightline test for real estate. That is it is intended to supplement the intention to sell test, with the idea that, if an asset is sold soon after it is purchased, there was an intention to sell, implying that any gain should be taxed as income.

Another potential rational would be to provide partial compensation for inflation. The idea would be that when assets are held for a long time a considerable portion of their gain reflects inflation rather than real income. The note addresses this issue.

Inflation and the taxation of capital income

It is well recognised that nominal income from capital assets overstates the real income arising from those assets in the presence of inflation. Economic income would remove this inflationary component. Numerous studies have examined the possibility of systematically removing the effects of inflation from the measurement of income for tax purposes. Notwithstanding its theoretical attraction, only Israel has introduced such as system. Other countries have employed ad hoc measures to compensate for inflation from time to time.

All capital assets suffer from the problem. The question is, should capital gains be singled out for compensation. The issue has some history. Tapering has been suggested as a method. Under tapering, the inclusion rate for capital gains would fall as the holding period increases. A short-term/long-term distinction can be seen as a simple form of tapering.

Comparing the effect of inflation on capital gains and interest income

The basic question is, is there a reason to single out capital gains for compensation from inflation? The Table compares the accumulated funds from a capital asset and a bond. In each case $100 is invested and a before-tax interest rate/price appreciation of 5% is earned. Inflation is assumed to be 2%. The tax rate is 40%. Various holding periods are assumed for the assets.

The Table compares four scenarios

- **Fully-taxed interest** on a bond, which is fully-taxed each year as it accrues.
- **Realised fully-taxed capital gain**, which is fully taxed when the asset is sold.
- **Long-term half-taxed capital gain**, which is one-half taxed if it is sold after five years or more.
- **Realised indexed capital gain**, the real indexed gain of which is taxed when the asset is sold.
- **Indexed capital income**, the real indexed portion of which is fully taxed each year as it accrues.

Accumulated Value					
Holding period	**1**	**5**	**10**	**25**	**50**
Full-taxed interest	103.0	115.9	134.4	209.4	438.4
Realised capital gain	103.0	116.6	137.7	243.2	728.0
Long-term (half-taxed) capital gain	103.0	122.1	150.3	290.9	937.4
Realised indexed capital gain	103.8	120.7	146.5	268.8	795.7
Indexed capital income	103.8	120.5	145.2	254.1	645.5

The **realised capital gain** outperforms the **interest** after the first year. The reason for this is the deferral of taxation that results from realisation taxation. The converse is that interest bearing securities are harder hit by inflation than assets earning capital gains.

This relative benefit would be increased if **long-term capital gains** were taxed at one-half rates.

1. Taxing **long-term capital gains** at one-half rates would provide more compensation than **indexed capital income**. **Indexed capital income** provides a benchmark for full inflation protection. Thus, a **long-term capital gain** system over-compensates for inflation. Even full taxation of **realised capital gains** can be better than indexed capital income, if the holding period is long enough.
2. The benefits of taxing **long-term capital gains** at one-half rates would even exceed taxing **realised indexed capital gains**.

Technical issues

The idea would raise a number of technical issues.

Retention of capital income boundary

The difficult border between capital and income account assets would need to be retained.

Lock-in

For assets with gains, there would be a significant lock-in effect in the period prior to the holding period limit. After that holding period, lock-in would be reduced due to the lower rate of tax.

Adverse selection

For assets with losses, there would be an opportunity to realise losses at full tax rates, while holding winners to be taxed at lower tax rates. This loss pressure could make it more difficult to allow losses to be offset against other income; imposing a tax on risk.

Conclusion

Officials do not recommend providing a reduced tax rate for long-term capital gains.

Expanded tables on indexation of capital gains

The tables show the build-up of after-tax capital for the investor under different tax and inflations scenarios. The tax build-up shows the accumulated tax under the assumption that the funds are invested by the government at the before tax interest rate. Thus all dollar amounts are shown as future values which allows consistent comparisons of amount within a year. A feature of this approach is that the sum of the capital build-up and the tax build-up is constant across tax scenarios within a year. Effective tax rates are nominal rates. Effective tax rates drop off more rapidly in the out years at higher inflation rates for the capital assets, emphasising the fact that realisation taxation provides a substantial benefit relative to the taxation of ordinary financial arrangements.

Inflation rate = 2%, Interest rate = 5%

		1	**5**	**10**	**25**	**50**
Fully-taxed interest	**Capital build-up**	103.0	115.9	134.4	209.4	438.4
	Tax build-up	2.0	11.7	28.5	129.3	708.3
	Nominal ETR	40%	40%	40%	40%	40%
Realised capital gain	**Capital build-up**	103.0	116.6	137.7	243.2	728.0
	Tax build-up	2.0	11.1	25.2	95.5	418.7
	Nominal ETR	40%	38%	35%	28%	19%
Long-term (half-taxed) capital gain	**Capital build-up**	103.0	122.1	150.3	290.9	937.4
	Tax build-up	2.0	5.5	12.6	47.7	209.3
	Nominal ETR	40%	19%	17%	13%	8%
Realised indexed capital gain	**Capital build-up**	103.8	120.7	146.5	268.8	795.7
	Tax build-up	1.2	6.9	16.4	69.8	351.0
	Nominal ETR	24%	23%	22%	19%	15%
Indexed capital income	**Capital build-up**	103.8	120.5	145.2	254.1	645.5
	Tax build-up	1.2	7.1	17.7	84.6	501.3
	Nominal ETR	24%	24%	24%	24%	24%

Inflation rate = 5%, Interest rate = 8%

		1	5	10	25	50
Fully-taxed interest	**Capital build-up**	104.8	126.4	159.8	322.9	1042.5
	Tax build-up	3.2	20.5	56.1	362.0	3647.7
	Nominal ETR	40%	40%	40%	40%	40%
Realised capital gain	**Capital build-up**	104.8	128.2	169.5	450.9	2854.1
	Tax build-up	3.2	18.8	46.4	233.9	1836.1
	Nominal ETR	40%	36%	32%	22%	13%
Long-term (half-taxed) capital gain	**Capital build-up**	104.8	137.5	192.7	567.9	3772.1
	Tax build-up	3.2	9.4	23.2	117.0	918.0
	Nominal ETR	40%	18%	15%	10%	6%
Realised indexed capital gain	**Capital build-up**	106.8	139.2	194.7	546.4	3272.8
	Tax build-up	1.2	7.7	21.2	138.5	1417.4
	Nominal ETR	15%	14%	14%	12%	10%
Indexed capital income	**Capital build-up**	106.8	138.9	193.1	517.9	2682.6
	Tax build-up	1.2	8.0	22.8	166.9	2007.5
	Nominal ETR	15%	15%	15%	15%	15%

Inflation rate = 10%, Interest rate =13%

		1	5	10	25	50
Fully-taxed interest	**Capital build-up**	107.8	145.6	211.9	653.8	4275.0
	Tax build-up	5.2	38.7	127.5	1469.2	40798.6
	Nominal ETR	40%	40%	40%	40%	40%
Realised capital gain	**Capital build-up**	107.8	150.5	243.7	1313.8	27084.2
	Tax build-up	5.2	33.7	95.8	809.2	17989.4
	Nominal ETR	40%	34%	28%	17%	9%
Long-term (half-taxed) capital gain	**Capital build-up**	107.8	167.4	291.6	1718.4	36078.9
	Tax build-up	5.2	16.8	47.9	404.6	8994.7
	Nominal ETR	40%	17%	13%	7%	4%
Realised indexed capital gain	**Capital build-up**	111.8	175.0	307.4	1707.2	31739.8
	Tax build-up	1.2	9.3	32.0	415.8	13333.8
	Nominal ETR	9%	9%	9%	8%	6%
Indexed capital income	**Capital build-up**	111.8	174.7	305.1	1625.7	26429.6
	Tax build-up	1.2	9.6	34.4	497.3	18644.0
	Nominal ETR	9%	9%	9%	9%	9%