Future of Tax

Interim Report

Tax Working Group

Te Awheawhe Tāke

'Nāu te rourou, Nāku te rourou, ka ora ai te iwi'

'With your contribution and mine, the people will prosper'

New Zealand Government

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Foreword

Taxation is a matter which can arouse strong passions, deep disagreements, and much confusion. That is, in part, due to two things.

The first is that while many people do not like paying tax, few want to do away with the services tax pays for: supporting the retired, health, education, infrastructure (including public transport), the protection of the environment, public order and much more.

The second, which helps explain the breadth and complexity of this interim report, is that arguably no forms of tax are all bad, neither are they all good. Taxes live in the world of greys, not that of black and white (much as some politicians as well as some economists might assert otherwise).

That reality underlies the fact this interim report does not arrive at firm or definitive conclusions on many issues. On some of the more controversial matters - such as the extension of the taxation of capital income - we have attempted to provide and explain various options.

On others, such as environmental taxes, we have been specific in some cases, more general in others. We also point the way towards longer term possibilities for systemic tax reform that may assist the transformation of our economy, consistent with and contributing to the Government's goal of zero net carbon emissions by 2050.

On a few matters, for example alteration to the structure of GST, we have been very clear in not supporting any such changes but point to the need for other policy levers to be used to address underlying problems.

The Tax Working Group recognises that there is a great deal more work to be done before we present our final report in February next year. This work will include, in particular, further consideration of the details of possible extensions to the taxation of capital income and the distributional consequences of various options for tax changes.

My hope is that people will consider their responses carefully to this interim report. The Group has a wide variety of people on it, yet we have produced a report which we can all recommend for that careful consideration. Feedback is welcome and can be sent to:

submissions@taxworkinggroup.govt.nz

Given the tight deadlines for the final report, feedback is appreciated as soon as possible.

Michael Cullen, KNZM
Chair, Tax Working Group
September 2018

Executive Summary

Nei rā ka tau mai rā te ao hurihuri nei; he hau mai tawhiti,
he tohu raukura nā ngā tīpuna.
Inā Te Tiriti o Waitangi tonu! He tauira, kōkiritia te kaupapa nei!
Rau rangatira mā.
Nāu! Nāku! Kia ora ai tātou.
Tēnā koutou. Tēnā tātou!
Kia ora tātou katoa!

As the changing world swirls about us, we muster wisdoms from our pasts to help, helping us to forge ahead in a new world. Bearing the raukura plume of our forebears, and the dignity of Te Tiriti o Waitangi, we can address, grapple with, and overcome this challenge!

Greetings all! We invite you to contribute and to participate – knowing that from everyone's efforts, new paths are found. Our greetings, and our acknowledgments to all.

Kia ora tatou katoa!

A national conversation on the future of tax

Over the past nine months, the Tax Working Group has engaged in a national conversation with New Zealanders about the future of the tax system. Thousands of New Zealanders – including iwi, businesses, unions, and other organisations – have had their say. It is clear to the Group that tax matters to everyone.

There is good reason for this passion. The tax system underpins the living standards of New Zealanders in three important respects: as a source of revenue for public services; as a means of redistribution; and as a policy instrument in its own right. The Group has been alert to these multiple purposes in the course of its work.

The Group also believes it is important to bring a broad conception of wellbeing and living standards to its work – including a consideration of Te Ao Māori perspectives on the tax system. This approach reflects the composition of the Group, which includes members with a diverse range of skills and experience, including from beyond the tax system.

The Group is currently working with stakeholders to develop a framework to support the future evolution of the tax system that reflects principles from Te Ao Māori, alongside the four capitals of the Living Standards Framework and the principles of tax policy design. This includes exploring concepts of waiora (wellbeing), manaakitanga (care and respect), kaitiakitanga (stewardship), whanaungatanga (relationships and connectedness), and ōhanga (prosperity).

Challenges, risks, and opportunities

The Group's Submissions Background Paper invited submitters to share their views on the challenges, risks, and opportunities facing the tax system. The Group has received thousands of submissions since the release of the *Submissions Background Paper*, and would like to thank all submitters for taking the time to share their views and perspectives on the future of tax.

Reading through the submissions, there appear to be five areas of common concern to New Zealanders:

- climate change and environmental degradation
- changes in business, technology, and the nature of work
- demographic change, in particular the aging of the population
- wealth inequality, and the progressivity, fairness, and integrity of the tax system
- the treatment of capital, savings (especially retirement savings), and housing in the tax system.

Submitters sometimes differed in their views about how these issues would affect the tax system, and how the tax system should respond to them. Nevertheless, there does appear to be a largely shared view about the challenges, risks, and opportunities ahead of us.

The structure, fairness, and balance of the tax system

One of the key tasks for the Group has been to assess the structure, fairness, and balance of the tax system. Although the tax system has many strengths, the Group has found that the tax system relies on a relatively narrow range of taxes, and is not particularly progressive. There are a number of reasons for these outcomes, but two issues stand out for the Group:

- **The inconsistent taxation of capital income**.
  A significant element of capital income – gains from the sale of capital assets – is not taxed on a consistent basis. This treatment reduces the fairness of the tax system. It also regressive, because it benefits the wealthiest members of our society. Both effects risk undermining the social capital that sustains public acceptance of the tax system.
- **The treatment of natural capital**.
  New Zealand makes relatively little use of environmental taxation. There are clear opportunities to increase environmental taxation, both to broaden the revenue base, and to help address the significant environmental challenges we face as a nation.

Interim conclusions

The taxation of capital income

In light of its findings on the structure, fairness, and balance of the tax system, the Group has devoted much time to the taxation of capital income. At present, the Group is examining the merits of extending the taxation of capital income.

Extending the taxation of capital income will have a range of advantages and disadvantages. It will improve the fairness and integrity of the tax system, and level the playing field between different types of investments. It will provide an increasing source of revenue over time; depending on design, it will also enhance the sustainability of the tax system (particularly if the difference between the company rate and the top personal rate increases in the future).

Yet extending the taxation of capital income will also increase administration and compliance costs, and could lead to some reduction in the overall level of saving and investment in the economy.

It is difficult to form a judgement about the strength of these impacts in the abstract. This is because the nature of the impacts will be heavily dependent on the details of policy design. It is also important to ensure that policy design is as simple and effective as possible, reaping all potential benefits while minimising potential disadvantages. The Group has thus decided to work through, in substantial detail, the policy choices involved in the design of an extended taxation of capital income.

The Group is currently considering two main options: an extension of the existing tax net (through the taxation of gains on assets that are not already taxed); and the taxation of deemed returns from certain assets (known as the risk-free rate of return method of taxation). The Group is not recommending a wealth tax or a land tax.

The Group has made good progress in determining what income might be included from certain assets, and when this income might be taxed – but there is still much work to do.

Retirement savings

New Zealand currently offers few incentives for retirement saving. KiwiSaver is targeted at providing greater proportionate benefits to those on lower incomes, but those on the bottom two marginal tax rate do not benefit from the fact that the top PIE rate is 28%.

The Group has identified opportunities to encourage saving among low- and middle-income earners, and make the tax treatment of retirement savings fairer. However, the treatment of retirement savings is interlinked with the treatment of capital income. The Group will need to give further consideration to the choices and trade-offs around retirement savings in the Final Report.

Housing affordability

It is also evident that New Zealanders are deeply concerned about the high cost of housing, and its impact on wealth inequality, social cohesion, and social capital. Consistent with these concerns, the Group has been directed to have special regard to housing affordability in its work.

The cause of unaffordable housing is, in one sense, straightforward. New Zealand has been unable to build enough houses to satisfy demand at current rates of population growth. This shortfall reflects a number of interlinked problems in the supply of housing – including land use constraints, infrastructure constraints, and high building costs.

The tax system is not responsible for constraints in the supply of housing, but it does influence demand for housing. Certain features of the tax system – such as the inconsistent treatment of capital income – have probably exacerbated the house price cycle in New Zealand, even if the tax system is not the primary cause of unaffordable housing.

The Group's work on housing affordability is closely linked to its work on the taxation of capital income. There is an open question as to whether an extension of capital income taxation would have a material effect on the housing market. A concern for the Group is to understand these impacts further.

Environmental and ecological outcomes

Another key task for the Group is to examine how the tax system can sustain and enhance New Zealand's natural capital for positive environmental and ecological outcomes.

The environmental challenges we face require profound change to the pattern of economic activity. It is necessary for policy-makers to think in terms of systems change – and to develop a set of goals and principles that can guide a transition, over many decades, to a more sustainable economy. Taxation is one tool – alongside regulation and spending measures – that can be used to support and guide this transition.

As an initial step, the Group has developed a framework for deciding when to apply taxes to address negative environmental externalities.

Box: Draft framework for taxing negative environmental externalities

The suitability of taxation as a policy instrument (relative to other potential instruments) can be assessed through the following principles: *measurability; behavioural responsiveness; risk tolerance;* and *scale*.

Taxation may be more useful as a policy response when there is a *diversity of responses* available to respond to the tax, and when there is significant *revenue-raising potential*.

There are also five design principles that warrant particular attention: *Māori rights and interests* and *distributional impacts* must be addressed; the *price of the tax* should reflect the full cost of externalities; the price should *vary locally* where there is local variation in impacts; and *international linkages* should be considered.

The Group believes there is significant scope for the tax system to play a greater role in sustaining and enhancing New Zealand's natural capital.

- In the short term, there may be benefits from expanding the coverage and rate of the Waste Disposal Levy, as well as strengthening the Emissions Trading Scheme, and advancing the use of congestion charging.
- In the medium term, there could be benefits from the greater use of tax instruments to address water pollution and water abstraction challenges. Addressing Māori rights and interests in fresh water should be central to any changes.
- In the long term, environmental taxes could help to address other challenges, such as biodiversity loss, and impacts on ecosystem services.

Corrective taxes

A tax on an environmental externality is a type of corrective tax – a tax that is primarily intended to change behaviour. Outside of the environmental sphere, New Zealand currently levies corrective taxes on the consumption of alcohol and tobacco. The Group also received many submissions calling for taxes on the consumption of sugar.

The Group is reluctant to provide recommendations on the rates of alcohol and tobacco excise, since these require the input of public health expertise that the Group does not possess. Yet the Group does see a need to simplify the schedule of alcohol excise rates, and is concerned about the distributional impact of further increases in tobacco excise.

The case for the introduction of a sugar tax must rest on a clear view of the Government's objectives. If the Government wishes to reduce the consumption of sugar across the board, a sugar tax is likely to be an effective response. If the Government wishes to reduce the sugar content of particular products, regulation is likely to be more effective. In either case, there is a need to consider taxation alongside other potential policy responses.

Goods and Services Tax (GST)

GST is an important source of revenue for the Government. Yet the Group has received many submissions calling for a reduction in the GST rate – or for the introduction of new GST exceptions (for example, for food and drink) – to reduce the impact of GST on lower-income households.

The Group acknowledges public concerns about the regressive nature of GST. Nevertheless, the Group has decided not to recommend a reduction in the GST rate, or the introduction of new exceptions.

In doing so, the Group does not wish to deny public concerns, but rather to point out that there are more effective ways to increase progressivity than changes to GST.

- The best mechanism to improve incomes for very low income households, for example, will be to increase welfare transfers.
- If the intention is to improve incomes for certain groups of low-to-middle-income earners (such as full-time workers on the minimum wage), then changes to the personal income rates and/or thresholds will be more effective.

One other problematic aspect of GST is the treatment of financial services. Financial services are not subject to GST for reasons of administrative complexity. The Group has considered a number of options for taxing the consumption of financial services, but has not been able to identify a means of doing so that is both feasible and efficient.

The Group does not recommend the introduction of a financial transactions tax at this point.

Personal income and the future of work

Personal income tax is the largest source of revenue for the Government. Alongside GST, it is the primary way in which most New Zealanders interact with the tax system. The fairness and integrity of income tax therefore bears directly on New Zealanders' views of the fairness and integrity of the tax system as a whole.

The Group has not yet finalised its views on the rates and thresholds for income tax, but notes that reductions to the lower rates and/or increases in the lower thresholds would be the most progressive means of assisting low- and middle-income earners through the tax system. The impact of inflation on income tax is best dealt with through periodic reviews of the thresholds.

Most income tax is collected through the PAYE system. PAYE is a withholding system in which employers are responsible for deducting and paying income tax on their employees' behalf. PAYE has served New Zealand extremely well, but its effectiveness will reduce if labour market changes increase the proportion of self-employed workers in the future.

The Group supports Inland Revenue's efforts to increase the compliance of the self-employed, and recommends further expansion of the use of withholding tax (including to digital platform providers, such as ride-sharing companies).

The Group has also discussed support for childcare costs to increase participation in the workforce, but believes this support is best delivered outside the tax system.

The taxation of business

Company tax is an important part of the revenue base. But the taxation of business also has a broader impact on wellbeing. It affects the accumulation of physical and financial capital across the economy; it affects social and human capital by changing the incentives for businesses to create employment and invest in the skills of their workers.

The Group believes that the current approach to the taxation of business is largely sound. The Group does not see a case to reduce the company rate, or to move away from the imputation system. The tax rate for Māori authorities also remains appropriate (although the rate should be extended to the subsidiaries of Māori authorities).

The Government asked the Group to consider the merits of a progressive company tax (with lower rates for small businesses). The Group recommends against the introduction of a progressive company tax on the basis that reductions in compliance costs are likely to be a more effective means of supporting small businesses. The Group is still forming its views on the best ways to reduce compliance costs and enhance business productivity.

The main focus of many submissions, however, was on the treatment of multinationals and digital firms. In this regard, the Group notes that New Zealand is currently participating in discussions at the OECD on the future of the international tax framework. The Group supports this process, but recommends that the Government stand ready to implement an equalisation tax on digital services if a critical mass of other countries move in that direction.

The integrity of the tax system

Most New Zealanders recognise the importance of paying tax, and meet their tax obligations. Some, however, do not. Tax avoidance reduces the integrity of the tax system and erodes social capital. It is also fundamentally unfair, because it means that compliant taxpayers must pay more in order to make up for the lost revenue.

A number of integrity risks have been addressed over the years. For example, the alignment of the trustee rate and the top personal income rate has greatly reduced the use of trusts to shelter income and avoid tax.

At the moment, however, there does appear to be an issue with the use of closely-held companies. Some of the underlying problems here derive from the fact that the company and top personal tax rates are not aligned, but there is a clear need for Inland Revenue to strengthen enforcement around the use of current accounts in closely-held companies.

The Group also recommends measures to reduce the extent of the hidden economy (i.e. undeclared and cash-in-hand transactions). These measures could include an increase in the reporting of labour income, and even the removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.

Tax collection could be enhanced by increasing the penalties for non-compliance. The Group recommends options such as making directors personally liable for arrears on GST and PAYE obligations, and departure prohibition orders in cases of serious wrong-doing. The Group also recommends the establishment of a single Crown debt collection agency, to achieve economies of scale and more equitable outcomes across all Crown debtors.

The Group also recommends that Inland Revenue continue to invest in the technical and investigatory skills of its staff.

The treatment of charities

Charities and not-for-profits make important contributions to the wellbeing of New Zealand. The activities of these organisations enhance the social, human, and natural capital in New Zealand. In turn, the Government supports the work of charities by offering tax exemptions for charity income, and tax benefits for donations to charities.

The Group has received many submissions regarding the treatment of business income for charities, and whether the tax exemption for charitable business income confers an unfair advantage on the trading operations of charities.

The Group's view is that the underlying issue is more about the extent to which charities are distributing or applying the surpluses from their activities (either active businesses or passive investments) for the benefit of the charitable purpose. If a charitable business regularly distributes its funds to its head charity, or provides services connected with its charitable purposes, it will not accumulate capital faster than a taxpaying business. The question, then, is whether the broader policy settings for charities are encouraging appropriate levels of distribution.

The Group is concerned about the treatment of private charitable foundations and trusts. These foundations and trusts benefit from the donor tax concessions, but are not required to have arm's-length governance boards or distribution policies. The rules around these foundations and trusts appear to be unusually loose.

The Group believes that the charity deregistration tax rules could be amended to more effectively keep assets in the sector, and also questions whether the current GST concessions for non-profit bodies are appropriate.

The Government has launched a review of the Charities Act 2005 to ensure it remains effective and fit-for-purpose. Some of the issues identified by the Group could potentially be addressed through this legislative review, or followed up through the Tax Policy Work Programme.

The administration of the tax system

Tax policy is given effect, day in and day out, through the administration of the tax system. The quality of administration is central to public perceptions of the legitimacy and fairness of tax policy; the effectiveness of administration will determine the Government's ability to achieve its policy intent in levying taxation.

Tax secrecy is a topical issue in tax administration at the moment.The Group believes there is a need for greater public access to data and information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publically available). Inland Revenue should review whether the information and data it currently collects offers the most useful insights, or whether other data sets would better respond to the needs and interests of the public.

The Group also believes there is a need to improve the resolution of tax disputes. The Group recommends the establishment of a taxpayer advocate service to assist taxpayers in disputes with Inland Revenue, and also wishes to ensure the Office of the Ombudsman is adequately resourced to carry out its functions in relation to tax.

The Group has discussed opportunities to improve the development of tax policy and legislation. In particular, the Group encourages Inland Revenue to engage in good faith consultation with a more diverse range of voices in the development of new policy.

Next steps

The Group has discussed many issues over the past six months – but also recognises that there is still much to do before the presentation of the Final Report in February 2019. This work will include further consideration of measures to extend the taxation of capital income, as well as analysis of the distributional impact of the various options for reform.

The Group believes there are real opportunities to improve the fairness, balance, and structure of the tax system. Yet the Group's views are by no means final, and feedback from all New Zealanders is very much welcome. Together, we can shape the future of tax.

Part I

Purposes and frameworks

1

The purposes of tax

1. Over the past nine months, the Group has engaged in a national conversation with New Zealanders about the future of the tax system. Thousands of New Zealanders – including iwi, businesses, unions, and other organisations – have shared their thoughts and had their say on the future of tax.

2. The views and suggestions have differed from submission to submission. Yet the Group has been struck by the depth of interest and passion expressed by all submitters on the issues before us. It is clear that tax matters to everyone.

3. There is good reason for the passion we have seen. If the ultimate purpose of public policy is to improve wellbeing, then few areas of public policy contribute as much to the wellbeing of New Zealanders as the tax system.

4. There are three main ways in which the tax system supports the wellbeing of New Zealanders:

   - **A fair and efficient source of revenue.** Taxes provide revenue for the Government to fund the public goods and services that underpin our living standards. The tax system thus represents a way in which citizens come together to channel resources for the collective good of society.
   - **A means of redistribution.** Taxes fund the redistribution that allows all New Zealanders, regardless of their market income, to participate fully in society. While much of this redistribution occurs through the transfer system, the progressive nature of the income tax means that the tax system also plays a role in reducing inequality.
   - **A policy instrument to influence behaviours.** Taxes can also be used as an instrument to achieve specific policy goals by influencing behaviour. Taxes influence behaviour by changing the price of goods, services, or activities; taxes can discourage certain activities, and favour others. In this way, taxes can complement – or even replace – traditional policy tools such as regulation and spending, depending on which approach reflects the most effective way to achieve society's goals. This may be particularly important in the environmental sphere.

5. In light of these perspectives, the Group has decided to take a rounded view on the purpose of the tax system. The tax system is essential as a source of revenue to the Government – but it is also an important tool that can be used positively to pursue distributional goals, shape behaviour, improve living standards, and develop sustainably. The Group has been alert to these multiple purposes in developing its recommendations.

2

Frameworks for assessing tax policy

1. The Group believes it is important to bring a broad conception of wellbeing and living standards to its work on the tax system. This approach reflects the composition of the Group, which includes members with a diverse range of skills and experience, including perspectives from beyond the tax system.

2. Many factors affect living standards, and many of these factors have value beyond their contribution to material comfort. Only a subset of those values can be captured in monetary terms, but non-monetary factors are key determinants of wellbeing and living standards. As an example, certain types of economic activity may increase material comfort, but reduce wellbeing overall, if the by-products of that activity degrade the natural environment.

3. To measure wellbeing comprehensively, income measures must therefore be supplemented with measures of other factors, such as health, connectedness, security, rights and capabilities, and sustainability. In the *Submissions Background Paper*, the Group referred to two perspectives for assessing the full range of impacts from tax policy: the Living Standards Framework, and the established principles of tax policy design.

The Living Standards Framework

4. The Living Standards Framework identifies four capital stocks that are crucial to wellbeing: financial and physical capital; human capital; social capital; and natural capital. Wellbeing depends on the sustainable development and distribution of the four capitals, which together represent the comprehensive wealth of New Zealand.

5. The Living Standards Framework encourages policymakers to explore how policy change affects the four capitals. It widens the scope of analysis to include a more comprehensive range of factors, distributional perspectives, and dynamic considerations. In this way, the Living Standards Framework is consistent in intent with international wellbeing frameworks such as the Sustainable Development Goals (Treasury 2018).

Te Ao Māori perspectives on wellbeing and living standards

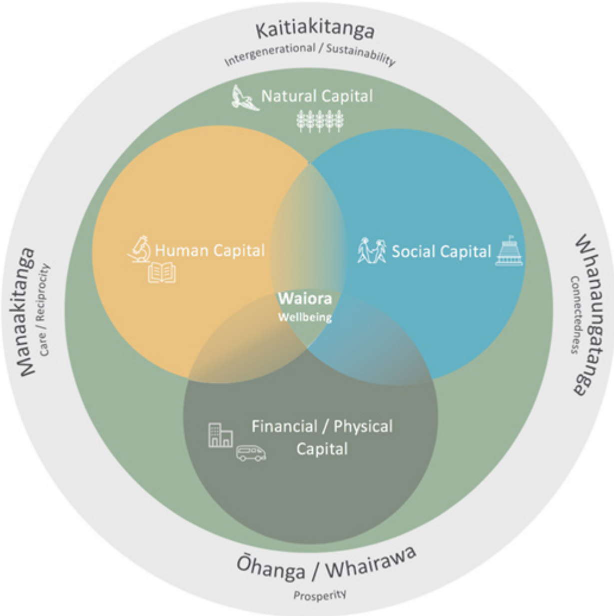
6. The Government has identified a need to explore how Te Ao Māori perspectives can inform our understanding and application of the Living Standards Framework. Consistent with this work, the *Submissions Background Paper* invited submitters to reflect on how tikanga Māori could help to create a more future-focussed tax system.

7. The Group is currently working with stakeholders to develop a framework that draws on principles from Te Ao Māori, and encompasses the four capitals of the Living Standards Framework, as well as the principles of tax policy design, to arrive at a more holistic view of wellbeing.

8. The framework is centred on the concept of waiora. Waiora is commonly used in Te Ao Māori to express wellbeing; it comes from the word for water (wai) as the source of all life.

9. The framework then draws upon four tikanga principles: manaakitanga (care and respect); kaitiakitanga (stewardship); whanaungatanga (the relationships/connections between us); and ōhanga (prosperity). These principles support the preservation and sustainable development of the four capitals of the Living Standards Framework.

Figure 2.1: Bringing together Te Ao Māori perspectives and the Living Standards Framework



10. The Group will conduct further engagement on the development and application of this framework in October, to ensure that the framework is meaningful, inclusive, and enhances tax policy development for Māori and all New Zealanders. This process will also inform the ongoing development of the Living Standards Framework.

11. While this framework is still under development, the Group has noted areas in subsequent analysis where tikanga concepts seem to have particular resonance – but this is very much a work in progress that will need to be fleshed out further in the Final Report, following further engagement with stakeholders.

The established principles of tax policy design

12. Previous tax reviews, in New Zealand and elsewhere, have used a relatively consistent set of principles to assess the design of the tax system. These principles are *efficiency, equity and fairness, revenue integrity, fiscal adequacy, compliance and administration costs,* and *coherence*.

13. Two further important principles in the tax system are *predictability and certainty* – meaning that taxpayers should be able to understand clearly what their obligations are before those obligations are due.

14. The Group believes these principles remain valid and useful in assessments of the tax system, particularly when considering the costs and benefits of options for reform. These principles complement the systems perspective offered by a broader living standards analysis.

Submitter perspectives on assessment frameworks

15. Many public submitters commented on the Group's choice of assessment framework. Most submitters supported the Group's decision to apply both the established principles of tax policy design and a broader Living Standards lens.

16. These submitters felt that the established principles provided a proven method of evaluating tax policy, while the Living Standards Framework ensured that the analysis would incorporate a fuller range of perspectives.

17. Māori submitters also encouraged the Group to bring a Te Ao Māori perspective to the design of the tax system.

18. A broader message the Group has taken from submitters is that it is necessary to bring a wide range of perspectives to bear on its analysis. This will ensure stakeholders have a clear understanding of the wellbeing and living standards impacts of the options before us.

Part II

Issues and challenges

3

New Zealand's current tax system

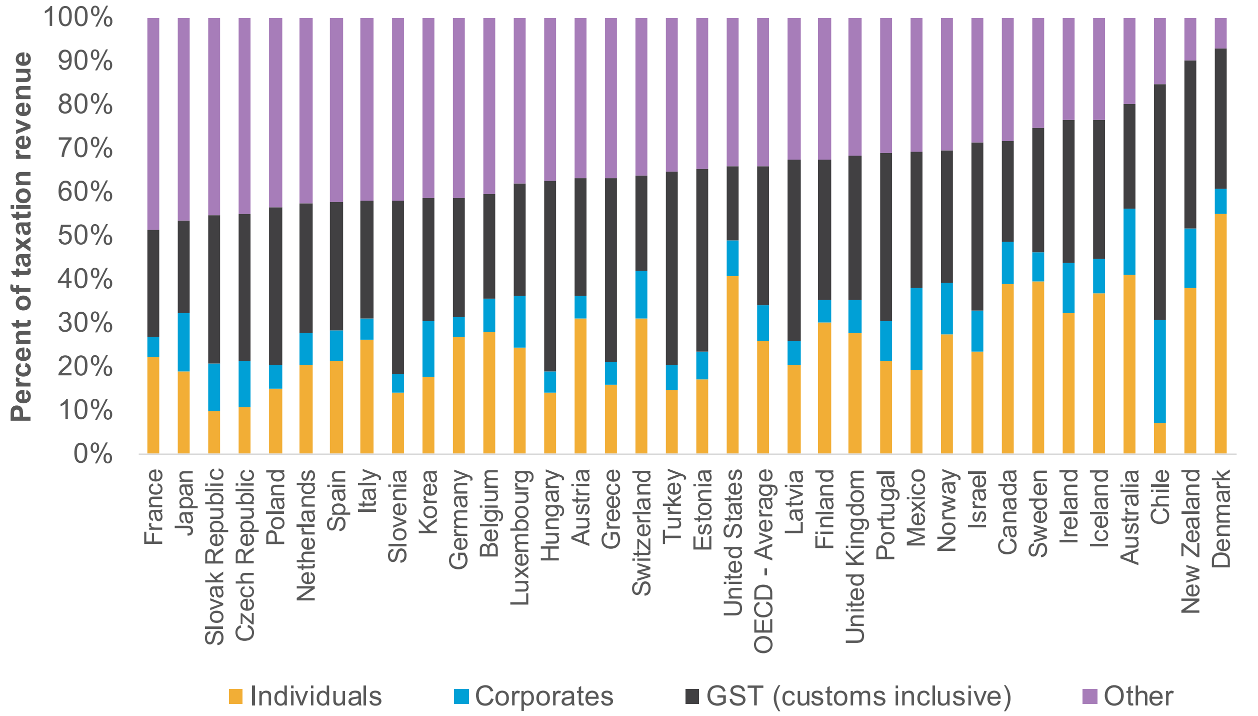
1. The Group's *Submissions Background Paper* explored the features of the current tax system in some depth. This chapter will revisit the key features of the tax system, with a focus on those features that are particularly distinctive about New Zealand.

The 'broad-base, low rate' tax policy framework

2. New Zealand's current tax system is underpinned by a tax policy framework known as 'broad-base, low rate.' In a broad-based system, there should be few exceptions to the base on which the tax is levied. The benefit of a broad-based system is that it allows the Government to raise substantial amounts of revenue at relatively low rates of taxation.

3. The 'broad-base, low rate' framework is reflected in the tax system's reliance on three main taxes: the personal income tax, the company income tax, and the Goods and Services Tax (GST). The Government raises about 90% of its tax revenue from these three taxes. This is a relatively narrow range of taxation, and means that New Zealand relies little on other potential sources of revenue, such as environmental taxation.

Figure 3.1: Source of taxation revenue, 2015 (OECD countries)



Source: OECD

4. The taxes that New Zealand does levy have relatively broad bases. This allows the Government to raise significant amounts of revenue at rates lower than in most OECD countries. Compared with other OECD countries:

   - New Zealand raises roughly equivalent amounts of revenue. Total tax revenue, including local government rates, stands at 32% of GDP. This is only slightly below the OECD average of 34% of GDP.
   - New Zealand has a low GST rate, and one of the lowest top personal tax rates, but collects high proportions of income tax revenue and GST revenue to GDP.
   - New Zealand's company rate is above average, and company tax revenue to GDP is high. After imputation, however, New Zealand's tax rate on domestic shareholders is the sixth-lowest in the OECD. New Zealand is more reliant on company tax revenue than most other OECD countries.
   - New Zealand raises little revenue from environmental taxation[1].

Distinctive features

5. New Zealand's tax system is quite distinctive in some respects. New Zealand makes little use of social security levies, environmental taxes, or corrective taxes (with the notable exceptions of alcohol and tobacco excise taxes, which are intended to discourage drinking and smoking). On the other hand, New Zealand's GST regime has few exceptions compared to other countries, and is therefore very efficient at raising revenue.

6. New Zealand's treatment of capital income also diverges from the approach taken by other countries. This is because New Zealand does not generally tax capital income in the form of gains. Thus, gains from the sale of shares and businesses, and some sales of land[2], are not generally taxed – whereas gains from financial arrangements and some sales of land are taxed.

7. New Zealand offers few concessions for retirement saving: retirement saving contributions are taxed when they are made and as investment income is earned, rather than when the savings are drawn down in retirement.

8. The other distinctive feature of New Zealand's tax system is the imputation regime, which prevents the double taxation of company income that is distributed as dividends. The imputation regime is discussed further in Chapter 14 on *The taxation of business*.

9. Outside the national tax system, rates are the primary source of revenue for local government. Rates are a narrow-based wealth tax on real estate. Local authorities in New Zealand, unlike their counterparts in most other jurisdictions, do not have the power to levy sales taxes, income taxes, or transaction taxes.

Distributional outcomes

10. There are different ways of measuring the distributional outcomes of the tax system. In absolute terms, higher-income households play an important role in funding the Government. The share of income tax paid increases as household income increases. Households in the top income decile pay around 35% of all income tax (on 30% of total household gross income), whereas households in the lowest five income deciles collectively pay less than 20% of all income tax (on 23% of total household gross income).

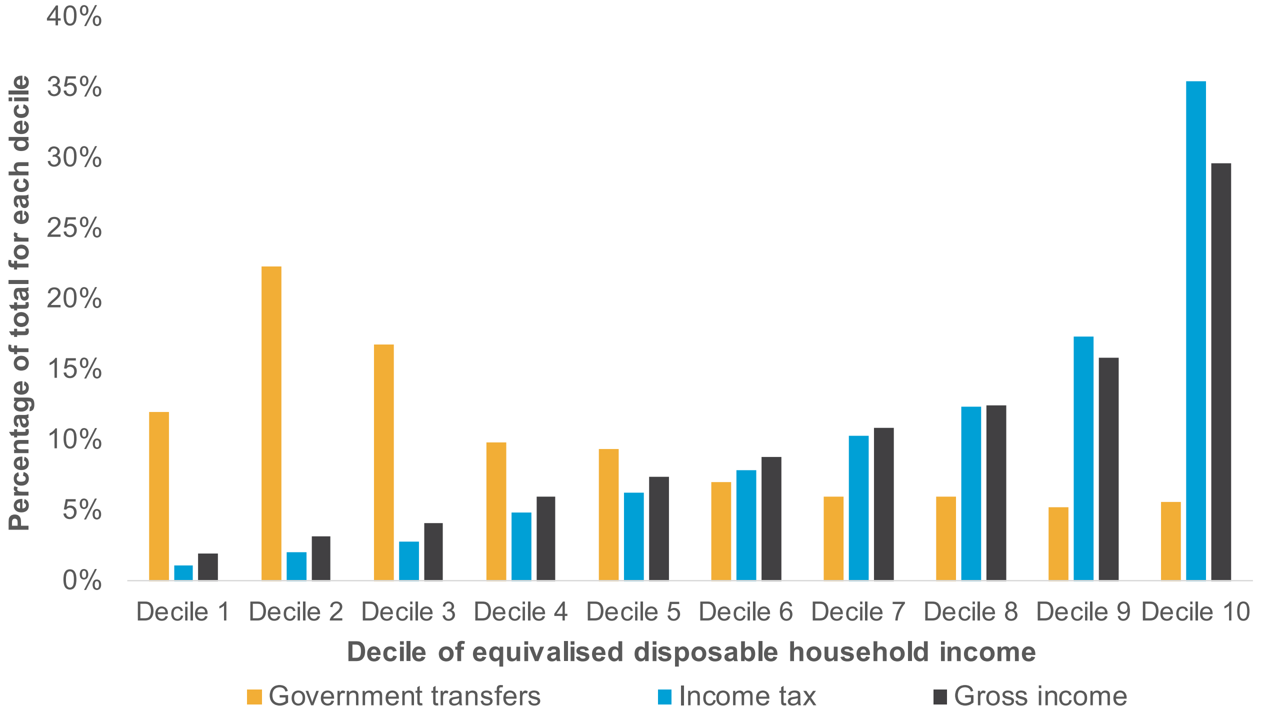
11. In other respects, however, the tax system is not particularly progressive. As Figure 3.3 illustrates, for example, there is not a significant increase in average effective tax rates across income deciles, even though the amount of tax *paid* increases by income decile.

12. Instead, progressivity is largely delivered through transfers, such as *Working for Families*. Figure 3.3 shows that households in the lowest four deciles do not, on average, pay any net tax after transfers are subtracted from income tax, GST, and ACC levies. There are higher net taxes as income increases.

1 See Tax Working Group, *Future of Tax – Submissions Background Paper* (2018) for sources.

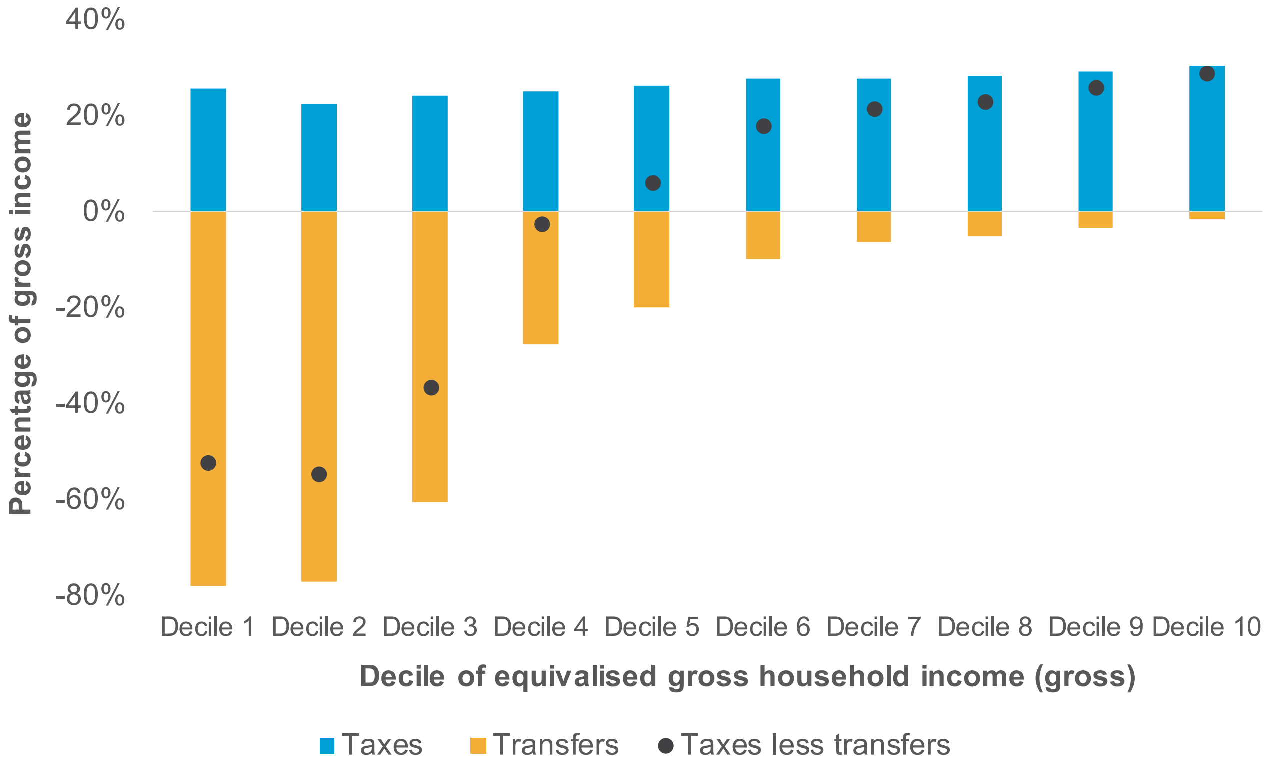
2 In this report, unless stated otherwise, "land" includes both the value of unimproved land as well as improvements to the land such as housing.

Figure 3.2: Percentage of income tax and transfers by income decile, 2014/15



Source: Bryan Perry, Ministry of Social Development, 2017 (data based on Household Economic Survey (HES) 2015).

Figure 3.3: Average effective tax rate (income tax, GST, and ACC levies less transfers), by income decile, 2012/13



Source: The Treasury (data based on HES 2013).

13. The inequality-reducing power of the tax and transfer system has fallen over the last three decades (Perry 2017). This outcome reflects the fact that the tax system and the transfer system have *both* become less effective at reducing inequality.

14. It is difficult to make cross-country comparisons on this issue, because the outcome may be affected by choices about which taxes are included and which are excluded for the purposes of the analysis. Figure 3.4 is based on the OECD Income Distribution database; it includes personal income taxes, employees' social security contributions, and cash transfers, but excludes payroll taxes and value-added taxes (including GST). Figure 3.4 illustrates that New Zealand's tax and transfer system reduces income inequality, but by less than is the case in Australia, or on average across the OECD.

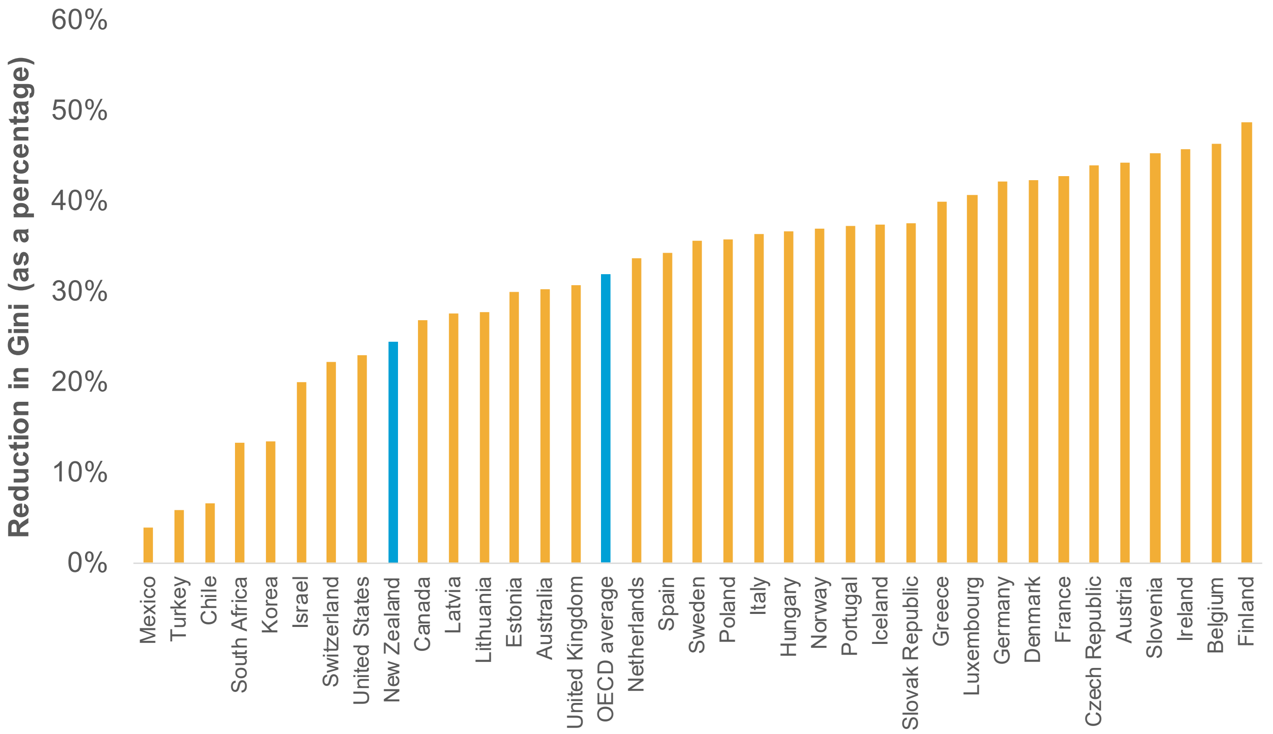
15. The progressivity of the tax system is also affected by the treatment of capital income. The incomplete taxation of capital income benefits the wealthy, whereas the absence of large concessions for retirement saving is a more progressive feature of the system.

Gender outcomes

16. As women's personal income levels are less than men's, they will pay less tax than men overall. Women also receive more in transfers than men. They therefore benefit less from tax reductions or tax concessions, and are more adversely affected by reductions in social welfare benefits. The average annual income of women is around $36,000, and the average income of men is around $54,000. The median annual income of women is around $26,000, and the median annual income of men is around $45,000.[3] Figure 3.5 shows the distribution of men and women by income decile.

17. The incomplete taxation of capital income is also likely to benefit men more than women, who have greater levels of personal wealth.

Figure 3.4: Reduction in Gini coefficient on account of the tax and transfer system, 2014/15



Source: OECD

3 Statistics New Zealand 2018 (Labour Market Statistics).

Figure 3.5 Distribution of males and females by annual personal income decile (people aged 15 years and over), 2015/16

Source: Statistics New Zealand.

Summary

18. Two key points emerge from this discussion of the current tax system:

    - **New Zealand relies on a relatively narrow range of taxes.** The Government raises about 90% of its tax revenue from only three taxes: the personal income tax; the company income tax; and GST. New Zealand makes little use of other sources of taxation, such as social security levies, environmental taxes, or corrective taxes. Thus, while the taxes that are levied have broad bases, the overall range of taxation is relatively narrow.
    - **The tax system is not particularly progressive.** Instead, progressivity is largely delivered through transfers, such as *Working for Families*. Yet New Zealand's tax and transfer system reduces income inequality by less than the OECD average. The progressivity of the tax system is also affected by the treatment of capital income. The inconsistent taxation of capital income from gains primarily benefits the wealthy.

19. In subsequent chapters, the Group will explore the issues and opportunities that arise from these key features of the tax system.

4

Issues and challenges raised by submitters

1. Tax systems have always evolved alongside changing practices in business, technology, and society. Today, however, change is particularly relentless, and technology is having a radical impact on the way businesses operate – both within and across national borders.

2. In the *Submissions Background Paper*, the Group identified eight challenges, risks, and opportunities that the tax system will face over the coming decade and beyond:

   - Changing demographics, particularly the aging population and the fiscal pressures that will bring.
   - Te Ao Māori and the role of the Māori economy in lifting New Zealand's overall living standards.
   - The changing nature of work.
   - Technological change and the different business models that will bring.
   - Falling company tax rates around the world.
   - Environmental challenges, including climate change and loss of ecosystem services and species.
   - Growing concern about inequality.
   - The impacts of globalisation and changes in its patterns.

3. The Group asked submitters to share their views on how these challenges and opportunities might affect the tax system. The Group also asked submitters to tell us whether we had missed any important issues.

Submitter perspectives

4. Submitters generally agreed with the issues that we identified. Reading through the submissions, there appear to five broad areas of common concern to New Zealanders.

Climate change and environmental degradation

5. The Group received a large number of submissions about the twin challenges of climate change and environmental degradation. New Zealanders are concerned about the state of the environment, and their concerns cover effects at the local, national, and global levels.

6. Yet there was also much debate about the role of the tax system in responding to these challenges. Many submitters are clearly looking to the Group to recommend the introduction of specific environmental taxes. Others question whether tax is the right instrument to address environmental problems.

7. In either case, most submitters stressed that tax should not be considered in isolation when dealing with the environment; instead, the merits of tax as a policy instrument should be assessed together with the merits of other tools and approaches.

Changes in business, technology, and the nature of work

8. Many submitters agreed with the Group that the tax system must respond to changes in business, technology, and the nature of work. Submitters highlighted four pressure points for our attention:

   - The erosion of the PAYE base as working arrangements change.
   - The growing importance of capital income relative to labour income.
   - The tax treatment of the digital economy.
   - International business activity.

9. Some submitters also signalled the importance of maintaining the international competitiveness of the New Zealand tax system, particularly in a context where corporate tax rates are falling in other countries. The Group has heard clearly from submitters that the tax system should support the productivity of the New Zealand economy.

10. Some submitters also suggested there is further scope to improve the administration of the tax system through investments in new technology.

Demographic change

11. Submitters acknowledged the impact of the ageing population, which will result in slower revenue growth and higher Government expenses on the health system and on New Zealand Superannuation.

12. For the Group, this point reinforces the importance of maintaining a sustainable revenue base over time. A sustainable revenue base must be flexible enough to respond to increasing demands for public services, yet provide reasonable certainty to taxpayers by signposting the direction of tax policy and avoiding unexpected policy shocks.

13. Some submitters also highlighted the increasing diversity of the New Zealand population. There will be an increasing proportion of Māori, Pasifika, Asian, and other ethnicities in the working age population over the coming decades. Submitters pointed to the need to reduce disparities between population groups and enhance the potential of all rangatahi (young people).

Progressivity, fairness, and integrity

14. Many submitters are worried that rising inequality will reduce wellbeing and social cohesion in New Zealand. Consequently, most submitters – but not all – expressed support for a more progressive tax system.

15. These concerns about the impact of inequality were often bound up with concerns about the fairness and integrity of the tax system. Many submitters argued that the inconsistent taxation of capital gains and the treatment of international business activity reduce the fairness and integrity of the tax system.

16. There were a number of submissions regarding the hidden economy and the effectiveness of tax collection. Submitters made the point that public buy-in to the tax system rests on the belief that all New Zealanders are paying their fair share of taxes. The Group agrees, and has prioritised the issue of the integrity of the tax system during the course of its work.

17. The Group also received submissions on the interface between the tax and transfer systems. The Terms of Reference exclude the Group from making specific recommendations on this subject, but the Group has been mindful of the tax/transfer interface in the course of its work, and is maintaining a dialogue with the Welfare Expert Advisory Group.[4]

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4 The Government established the Welfare Expert Advisory Group in May 2018 to conduct a broad-ranging review of the welfare system. Among other things, the Welfare Expert Advisory Group has been tasked to develop recommendations for improving Working for Families, and to examine other areas where the interface with the welfare system is not functioning well.

Capital, savings, and housing

18. The issues of capital, savings, and housing recur throughout the submissions. It is clear to the Group that these issues lie at the heart of public concerns about the tax system. Indeed, the treatment of capital, saving, and housing is inextricably linked to judgements about the structure, fairness, and balance of the tax system as a whole.

19. The submissions ranged widely. Many submitters are concerned about the extent to which the tax system affects saving and investment decisions. There were particularly strong views about the impact of the tax system on the housing market. Submitters also made vigorous arguments for and against tax reductions, especially on retirement savings.

20. Having read through these submissions, the Group has devoted considerable time to the taxation of capital, savings, and housing. Our task is to chart a way forward on these issues that is fair, durable, and efficient.

5

The structure, fairness, and balance of the tax system

1. The Group has been asked to assess the structure, fairness, and balance of the tax system. These are subjective concepts, and there are different ways to work towards a judgement on them. The Group has borne the following questions in mind in the course of its work:
    - Does the tax system treat income consistently, no matter how it is earned and in which sectors it is earned?
    - Does the tax system minimise opportunities for tax avoidance?
    - Are the bases of the tax system likely to be sustainable over time?
    - Should taxation be used as a tool to influence behaviour?
2. This chapter will begin to form a judgement on these questions through two lenses: the treatment of financial and physical capital; and the treatment of natural capital stocks.

Concepts of income

3. Underlying these judgements are some key assumptions about what constitutes 'income.' Income may be an easy word to say, but it has many different meanings.
4. There are accounting definitions of income, and economic definitions of income. 'Haig-Simons income,' for example, is defined as 'consumption plus changes in net worth' (JCT 2012). Then there are welfare definitions, which are used to assess whether an individual is eligible for income-tested benefits, and lay definitions, which might be as simple as 'cash in hand.' All of these forms of income can be represented in either nominal or inflation-adjusted terms. Natural capital can also generate 'income' in the form of ecological services.
5. A second set of definitions relates to the taxable unit. In the tax system, this may include individuals, households, and entities such as companies and trusts. Dominant cultural assumptions, for example regarding the definition of the family, underpin the use of these definitions within the tax system.
6. None of these concepts of income are right or wrong. They are all relevant in certain contexts. The challenge for policymakers is to think about what definition of income and taxable unit will be most appropriate in the context of each policy decision.
7. In this regard, the differences in income definitions between the tax and welfare systems appear to be particularly problematic, because they create confusion for individuals trying to understand their entitlements when they move in and out of the welfare system. The Group considers that this issue would be most appropriately considered by the Welfare Expert Advisory Group.

Labour income and capital income

8. A first way of judging the structure, fairness, and balance of the tax system is to assess whether income appears to be treated in a consistent manner, no matter how it is earned.
9. Income in the tax system is divided into two broad categories: labour income and capital income. Labour income is income earned from performing services (such as a wage or salary), or from personal exertion. Capital income is income earned from an asset.

10. Labour income is taxed through the income tax. Much capital income is taxed as well. Interest, rents, royalties, and receipts earned in the ordinary course of business are all subject to income tax. The tax rate depends on the type of entity earning the income.[5] Companies, for example, are taxed at a rate of 28%, whereas individuals are taxed on a progressive scale.[6]

11. However, there is a significant element of capital income which is generally not taxed – receipts which often come from the sale of capital assets. This element of capital income is commonly known as 'capital gains.' While currently generally outside the tax system, realised capital gains provide a basis for consumption in the same way as labour or interest income.

General principles

12. New Zealand's income tax law is founded on a distinction between income (or 'revenue') gains and expenditure, which are taxed and deductible, and capital gains and expenditure, which are exempt and non-deductible.[7]

13. In principle, gains derived in the ordinary course of carrying on a business are income and therefore taxable, and other gains are generally exempt. In practice, it is often difficult to draw this distinction, because it depends on judgements about a person's intentions, the nature of their business, and the role of a particular asset, liability or payment within that business.

14. New Zealand already taxes some payments that used to be treated as capital payments. Examples of taxable capital gains include lease inducement and surrender payments, proceeds from the sales of patents, and gains from certain land sales. The rationale for doing so, in general, is that these payments are particularly substitutable for taxable income.

15. Sometimes tax avoidance law applies to tax a capital gain. For example, some share sales are taxable on the basis that they include income that would otherwise have been received as dividends. In this case, the basis for taxation is a judgement that, in substance, the gain 'should' be taxed – even if the ordinary application of the law would place the gain on capital account.

Gains from specific classes of physical and financial capital

Land

16. Gains on the sale of land are taxable if the land was bought with a purpose or intention of resale, even if resale was not the only or dominant purpose or intention of the purchase. Capital losses are generally not deductible unless a gain on the sale of the property would be taxable.

17. The bright-line test for residential property sales aids the enforcement of this rule. It serves as a proxy for 'purpose of disposal' – which can otherwise be difficult to enforce – by taxing the sale of any residential property within five years of purchase, subject to some exceptions. The most important exception is that the family home is generally excluded from the test.

18. Capital gains on owner-occupied homes are not generally taxed. There are two main exceptions: the 'main home' exclusion from the bright-line test can only be used twice in a two-year period; and owner-occupiers with a regular pattern of buying and selling residential land cannot use the 'main home' exclusion for the land sale rules, including the bright-line rule.

19. Land affected by changes to zoning, consents, or other specified changes may be taxed on sale, if the sale is within ten years of acquisition. If at least 20% of the gain on disposal can be attributed to the change, the whole gain is taxable. However, the taxable amount is reduced by 10% for each year the taxpayer has owned the land.

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5 Subsequent chapters will explore further the taxation of savings and the treatment of taxable entities.

6 When a company pays a dividend then generally the income from the company will effectively be taxed at the personal level if the shareholder is a New Zealand resident.

7 Much capital expenditure, however, is deductible over time through depreciation.

20. Land disposals may be taxed if an undertaking or scheme involving more than minor development or division of the land was commenced within ten years of the land being acquired. Land disposals may also be taxed if there has been an undertaking or scheme of division or development of the land that involves significant expenditure on specified works, subject to a number of exclusions.

21. Most of the land sale rules represent attempts to codify or buttress common law principles that would have made land sales taxable in any event. Because the principles are factually dependent, however, the rules also tend to be factually dependent, and have given rise to much uncertainty and litigation. They are also difficult to enforce at a practical level.

Shares in New Zealand companies

22. Gains on shares are only taxable if they have been acquired for the dominant purpose of disposal, or in the course of a person's share dealing business. Shares are otherwise held on capital account, and gains on those shares are not taxable.

23. In practice, it can be difficult to determine the dominant purpose of acquisition, or whether a person is a share dealer who acquired the shares in the course of their business. Although most people acquire shares with a view to selling them at some later time for a profit, this fact is insufficient by itself to satisfy the 'dominant purpose' test.

24. Enforcement is difficult. Taxpayers tend to take the view that they have not acquired shares with a purpose of resale; the case law is extensive and contains many decisions that taxpayers can use to justify a revenue-unfavourable outcome. Yet the law also creates uncertainty for taxpayers, and it can be costly for taxpayers to defend if Inland Revenue decides to audit a transaction.

25. Several aspects of the regime for taxing companies and shares in companies are worth exploring in more detail:

- **Shares held by portfolio investment entities (PIEs).** Gains on Australasian shares held by PIEs are not taxable. This treatment is a response to the fact that gains on shares held by individuals are in practice rarely taxable. Applying a different approach to PIEs would have created a bias against the use of managed funds for equity investment, so managed funds operating as PIEs are exempted from taxation on the sales of New Zealand and Australian shares.

- **Non-portfolio professional investors.** There is uncertainty regarding the treatment of share sale gains and losses by angel, venture capital, and private equity investors. In practice, gains to these investors are rarely returned as taxable and losses are rarely claimed as deductible.

Shares in foreign companies

26. The fair dividend rate (FDR) method is generally used to tax portfolio investment in foreign shares (other than in Australian listed companies). Shares are generally taxed on a 5% deemed return, based on the opening value of the shares in each year. Actual dividends and sale proceeds are not taxed. However, in any given year, individuals and family trusts can pay tax on the actual return from their foreign share portfolio (including accruing gains and losses) if it is lower than the deemed return.

27. FDR is intended to raise revenue, while reducing the bias against foreign equity investment through managed funds. For domestic shares, this bias was dealt with by exempting PIEs from tax on gains from sale. But this approach would be problematic in relation to foreign shares. Since the income of foreign companies is not taxed unless it is earned in New Zealand, and such companies often do not pay large dividends, a failure to tax the gain on sale would allow most of the return from the investment to escape the domestic tax system. The solution was to tax both individuals and funds on a reasonable – but approximate – deemed return.

28. The following approaches apply for direct investment where the shareholder owns more than 10% of the non-resident company:

- **Controlled foreign companies.** The capital/revenue distinction applies to controlled foreign companies, with the result that most gains on sale are not taxable and most losses are not deductible. However, income from holdings in passive investments is directly attributed to the shareholders.
- **Other types of direct investment.** In other cases, the shareholder can generally choose between treating the investment as a portfolio investment (in which case it is taxed under the FDR method) or in a similar fashion to shares in a controlled foreign company (in which case there is attribution if the holding is passive).

Capital losses and expenses

29. The capital/revenue test applied by the courts denies deductions for capital expenses, but deductions are allowed by statute for many types of expenditure that would otherwise sit on capital account. This includes deductions for depreciation. Depreciation deductions initially applied only to tangible property, but have been extended to apply to forms of depreciating intangible property, such as computer software, and even to the costs associated with unsuccessful attempts to acquire certain types of property.

30. No deductions are allowed for the cost of acquiring goodwill (since payments received for goodwill are not taxable). Building depreciation deductions were abolished in 2010.

Assessment

31. There are inconsistencies in the current treatment of capital income. Much capital income is taxed, but income from the sale of capital assets is often not taxed. The most significant forms of capital income outside the tax net are gains from the sale of land (including housing), shares (other than portfolio investment in non-resident companies), businesses, and intellectual property, in cases where those assets have been acquired for a purpose other than sale.

The treatment of sectors and industries

32. A second way of judging the structure, fairness, and balance of the tax system is to assess whether the tax system deals with different sectors and industries in a broadly consistent way. An analysis of effective company tax rates can provide an insight into this issue.

The lens of effective tax rate analysis

33. New Zealand's statutory company tax rate is 28%. However, companies may pay a rate of tax on their accounting profit that is different to the statutory tax rate. This outcome may arise due to differences in how tax rules apply to companies, and differences between taxable income and accounting income.

34. The effective tax rate compares the amount of income tax paid by a company with their accounting profit before tax. It can be defined as follows:

$$\text{Effective tax rate} = \frac{28\% \times \text{Total group taxable income (before losses brought forward)}}{\text{Accounting profit before tax}}$$

35. Effective tax rates can provide a high level indication of where there may be under-taxation of companies, in particular where companies are paying a low level of tax relative to their accounting profits. What this means is the actual tax rate paid by the company can vary from the statutory rate of 28%. For example, if half of a company's profit were untaxed capital gains it might have an effective tax rate of 14% rather than the statutory tax rate of 28%.

36. Yet there are a number of limitations to effective tax rate analysis. Perhaps the most significant is that low effective tax rates can reflect the impact of deliberate policy choices such as the introduction of tax concessions in certain industries.

37. Additional caveats to effective tax rate analysis include:

- Effective tax rates look at the income tax paid by companies, not by their shareholders or other entities. In some instances, under-taxation will be 'corrected' by the dividend or imputation rules.

- The results are sensitive to the choice of time period.
- New Zealand has thin markets, so the results of a small number of firms can significantly skew sector analysis.
- Accounting may not be the most appropriate measure for considering income tax as it is more accrual-based than income tax is.
- There are margins of error associated with data quality and technical issues.

Effective tax rates by sector and industry

38. Inland Revenue and the Treasury have calculated the effective tax rates of significant enterprises in a number of industry groups (Inland Revenue & Treasury 2018). This analysis indicates that some industries appear to pay a low amount of tax relative to their accounting profit.

39. There may be valid reasons for tax treatment to differ from accounting treatment. Some companies may be earning foreign income that is not taxed in New Zealand, and there are areas where tax rules differ from accounting rules (for example, relating to the treatment of depreciation).

40. The most significant cause of low effective tax rates, however, appears to be untaxed income in the form of gains from capital assets. A more consistent approach to the taxation of this form of capital income would bring effective tax rates closer to statutory rates in many industries. Taxing gains on disposal would not, however, have much of an impact on industries that hold assets for the long term. It would also not impact industries where income is already subject to tax, but there are significant timing benefits for deductions.

41. The Group also notes that some industries benefit from deliberate tax concessions. Examples include accelerated deductions for certain types of farming, film, and forestry expenditure, as well as petroleum mining. The Government should keep these concessions under periodic review to ensure they remain consistent with its policy intent.

Natural capital

42. This chapter has thus far assessed the structure, fairness, and balance of the tax system from a traditional tax perspective. A broader Living Standards Framework perspective would consider the relationship between natural capital and the tax system, and acknowledge natural capital as a profound and non-substitutable basis for the economy.

43. Natural capital is not prominent in current conceptions of the tax system. As discussed in Chapter 3, New Zealand makes little use of environmental taxation. There is also little or no consideration of natural capital impacts in the development of new tax policy, and no reporting on the environmental impacts of current tax policy.

44. Yet taxation could serve as an important policy instrument to achieve our environmental objectives. Placing a price on polluting activities would help to ensure that polluters faced the full costs of their activities; there is also a choice to go even further and use environmental taxation to promote broader changes in the pattern of economic activity (alongside other policy instruments, such as spending and regulation). The additional revenue could also be used to support a transition to a more sustainable economy.

45. Given the non-substitutable nature of natural capital, the declining state of New Zealand's environment, and the increasing fiscal costs of mitigation and adaptation, the Group sees a case to broaden the base of the tax system and make greater use of environmental taxation. These issues are developed further in Chapter 9 on *Environmental and ecological outcomes*.

Overall judgements

46. This chapter has assessed the structure, fairness, and balance of the tax system through two lenses: the treatment of income from physical and financial capital; and the treatment of natural capital.

47. There are inconsistencies in the treatment of some forms of capital income. These inconsistencies raise a number of concerns for the Group:

    - **Fairness.** The inconsistent treatment of capital income is unfair. This unfairness will only increase if the economy becomes more capital intensive through a greater use of technology replacing labour.
    - **Distributional impact.** It is the wealthiest members of society who benefit the most from the inconsistent taxation of capital income. There is a risk that this regressive outcome erodes the social capital that sustains public acceptance of the tax system.
    - **Revenue sustainability.** As the population ages, a greater proportion of the population will live off capital income in retirement. The economy is likely to become increasingly capital intensive and capital income, when compared to labour income, is increasing. A tax base that is sustainable over time – and that is fair in an intergenerational sense – will need to draw more upon capital income as well as labour income.

48. There are many considerations involved in the extension of the taxation of capital income. Chapter 6 on *Capital and wealth* will explore these considerations in greater depth, and begin to outline a number of options for broadening the tax base further.

49. There are also clearly opportunities to increase the use of environmental taxation[8]. The Group has prioritised considerations of environmental taxation during the course of its work. Chapter 9 on *Environmental and ecological outcomes* introduces a framework developed by the Group for deciding when to apply environmental taxes, and shows how this framework could be applied to different stocks of natural capital.

8 Taxation in this context refers to economic instruments that can be potentially revenue raising for central or local government.

Part III

Interim conclusions

6

Capital and wealth

1. The Group is considering the structure, fairness and balance of the tax system as it applies to wealth generally and capital income specifically. The Group has examined the merits of changing the tax system through extending the taxation of capital income to asset classes presently treated as giving rise to exempt capital gains. For the purposes of this chapter, capital is being used in its traditional sense of a factor in production rather than as a component of the living standards framework.

2. The Group is considering two main options for extending the taxation of capital income. These are taxing realised gains not already taxed from specific assets and taxing certain assets on a deemed return basis (a risk-free rate of return method, as an example). After consideration, the Group is not recommending either a general wealth tax or a land tax[9] for the reasons given at the end of this chapter.

3. Whether an extension of the taxation of capital income is assessed under either traditional tax principles or the living standards framework, its effectiveness will be dependent on its design. The Group has therefore sought to establish design principles or rules under which the taxes might be implemented, so that Government or affected taxpayers can consider all the consequences. Only once such an extension is designed can a meaningful comparison take place between the two options, or a combination of those options, and the status quo.

4. The Group has made good progress in the past six months in determining what income might be included from certain assets and how and when the income might be taxed. The Group is not currently in a position to make specific recommendations, but is intending doing so in the Final Report.

5. This chapter:

   - Sets out the main policy considerations necessary for forming an overall judgement on extending the taxation of certain types of capital income. For the rest of this chapter it will be referred to as simply *capital income*.
   - Records a summary of the Group's views on the design features for extending the tax on realised capital gains.
   - Comments on the risk-free return method, wealth and land taxes.

6. Greater detail on extending the tax on realised capital gains is contained in Appendix B on *Design Features for Extending the Taxation of Capital Gains*.

9 As discussed below, a land tax is a tax on the *unimproved* value of land.

Policy considerations

7. The 2017 OECD Economic Survey of New Zealand, as part of its analysis that New Zealand should adopt a broad-based capital gains tax, included a useful summary of the advantages and disadvantages (see Table 6.1 below).

8. The Group considers that this is a fair reflection of the key advantages and disadvantages expressed simply. However, in order to be able to recommend the implementation of such measures the Group will need to form the following overall judgement:

In broad terms, will the **fairness, integrity, revenue, and efficiency benefits** from reform outweigh the **administrative complexity, compliance costs, and efficiency costs** that arise from the proposed additional capital income taxation?

9. The following sections outline the main considerations for and against reform. This is to give a sense of the main issues at stake as the Group forms its views over the following months.

The long-term sustainability of the tax system

10. New Zealand, like other countries, faces growing fiscal pressures from an ageing population. Taxing capital income that is currently untaxed is likely to provide a significant and growing revenue base for the future. Such gains are the single largest source of income that other countries tax and that New Zealand largely does not.

Table 6.1:

Advantages	Disadvantages
Increase progressivity of the tax system.[1]	Inefficient lock-in due to incentive to hold on to assets to avoid paying capital gains tax.
Improve horizontal equity by taxing income whether it is earned on capital gains or otherwise.	Taxes accrue on nominal as well as real gains.[2]
Improve efficiency through reducing tax-driven incentive to make investments in assets that provide capital gains rather than income, in particular housing.	In the absence of other tax changes, can discourage saving and investment through reducing post-tax returns, particularly if there are strict limits around relief for capital losses.
Reduce incentive to shelter income from tax by transforming ordinary income into capital gain.	Taxing gains on shares has potential for some double taxation of retained profits on which company tax has already been paid.[3] [10]

1. US and Australian evidence indicates that taxation of capital gains is highly progressive. This is likely to be the case for New Zealand too, as the distribution of wealth is more unequal than that of income: the top 20% of NZ households own almost 70% of net wealth and more than 75% of net wealth excluding owner-occupied dwellings (Statistics NZ, 2016).
2. This is a feature of nominal tax system more broadly and is more important for taxation of interest-bearing assets. Because capital gains taxed on realisation benefit from deferral of tax payments, real after-tax gains increase over time and thus capital gains are less affected by taxation of nominal gains than are interest-bearing assets (Burman, 2009).
3. Retained profits are not subject to full double taxation to the extent that there is a value placed on unused imputation credits that can be used for future dividends, as this value will be capitalised into the value of the company and thus increase capital gains (Burman and White, 2009)

Source: OECD (2006), *Taxation of Capital Gains of Individuals: Policy Considerations and Approaches*, OECD Tax Policy Studies No. 14; OECD (2011), *OECD Economic Surveys New Zealand*, OECD Publishing; Tax Working Group (2010), *A Tax System for New Zealand's Future*, Report of the Victoria University of Wellington Tax Working Group; Treasury and Inland Revenue (2009), "The Taxation of Capital Gains", *Background Paper for the Tax Working Group*.

10 This issue is discussed in detail in Appendix B.

11. Taxing more capital income also taxes more income from land. Land has the advantage of being an immobile tax base, unlike financial capital and labour, which are increasingly mobile due to macro trends such as technology advances and globalisation. Broadening the tax base to include more income from land therefore helps to diversify and provide more flexibility in the system to respond to future changes.

12. Another important sustainability question, relates to the structure of the tax system. Despite the relatively small gap between our company tax rate and top personal tax rate, we already have integrity problems with people using company structures to lower their taxes. This is discussed further in Chapter 15. These pressures are only likely to grow if the company rate is lowered or the top personal rate is raised. Both of which are respectively high and low on average by international standards. A tax on realised gains on shares in effect forces retained earnings to be attributed to individual shareholders and in this way can, to some extent, reduce the scope for companies to be used to shelter personal income from higher rates of tax.

Fairness

13. A sense of fairness is central to maintaining public trust and confidence in the tax system. This is because a system that distributes the costs of taxation in a way that is perceived to be unfair will generate resentment and undermine social capital. Perceptions of unfairness will erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance that underpins efficient tax collection.

14. The tax system is inconsistent in its treatment of capital income because it does not generally tax gains from the disposal of capital assets. This inconsistent treatment compromises commonly understood notions of fairness in two ways:

    - **Horizontal equity.** Individuals earning the same amount of income face different tax obligations, depending on whether they earn capital gains or other forms of income.
    - **Vertical equity.** Higher income individuals and households tend to derive a greater proportion of their income from increases in values of capital assets than lower income individuals and households. The Group has received estimates from Treasury that, in New Zealand, 82% of assets potentially affected by an extension of the taxation of capital income are held by the top 20% of households by wealth. The current approach can be regressive if it results in lower tax obligations on those with greater economic capacity to pay.

15. The lack of a general tax on realised capital gains is likely to be one of the biggest reasons for horizontal inequities in the tax system. People with the same amount of income are being taxed at different rates depending on the source of the income.

16. Untaxed realised gains are estimated to be approximately 20% of accounting profits for SMEs.

17. Evidence from overseas and data on wealth in New Zealand suggests that capital gains are concentrated amongst those with high incomes and wealth. Including more capital gains in the tax system is likely to be the most feasible way to make the tax system more progressive without increasing tax rates.

18. Reform could therefore reduce inconsistency in the treatment of individuals, increase the progressivity of the tax system and enhance or maintain social capital.

Economic and efficiency impacts

19. The effects of an extension of the taxation of capital income from the perspective of economic efficiency are complex to assess due to a range of factors that can move in different directions. Regard will need to be had to the impacts any changes will have on encouraging and/or not inhibiting the flow of investments to underpin sustainable productivity growth. Specific impacts will ultimately depend on the detailed design and who actually bears the cost of the tax.

20. These impacts could include:

    - A reduction in domestic private saving and investment in the affected assets. The ultimate impact on investment in those assets would depend on the degree non-residents and the government made up any shortfalls.
    - Savings and investment decisions becoming more neutral, thereby encouraging investment to flow to areas of greatest productivity rather than tax advantage. This may involve unaffected investment such as bank deposits and non-property based businesses becoming more attractive to investors.
    - Assets held on to for longer than is economically efficient to avoid taxation based on realisation – known as *lock in*. The degree of this effect will depend on the scale and design of any rollover relief associated with the tax.
    - The ability to bring capital expenditure – such as black hole expenditure or building depreciation - into the tax base if the equivalent income became taxed. This would improve the neutrality of the tax system.

21. In some cases, taxing New Zealand owners of assets will have little or no impact on asset price. This is particularly when:

    - capital gains form a minimal part of the return;
    - foreign investors largely set the return from and price of particular assets,[11] such as many shares listed on the NZX.

22. In other cases, an extension of capital income taxation will be more likely to result in a fall in the price of the asset. For example, it may be difficult for farming and agriculture businesses to pass on additional taxes by charging more for their products if the products are sold on world markets and New Zealand is a price taker on these markets.

23. Experience here and overseas has demonstrated that savings can be especially sensitive to tax differences between different forms of saving and different savings vehicles. Over the past almost fifty years New Zealand has reduced the extent that savings are treated differently depending on the saving vehicle used – life insurance, direct share investments, investment funds etc.

24. The Group is therefore mindful of how any differences in the treatment of capital income might distort capital markets. For example, taxing individual share investments more harshly than the same investments through institutions could lower returns, undermine our equity markets and ultimately lead to New Zealand companies migrating offshore. We are considering these issues further.

25. An important concern of an extension of capital income taxation is the impact on the housing market. Many submitters have been concerned that tax-free gains on houses encourages New Zealanders to place a high proportion of savings in land and housing leaving lower New Zealand savings for other forms of investment.

26. The Group has discussed the impact on housing from a first principles basis, reviewed modelling work that attempts to disentangle various effects, and looked at what has happened when capital gains taxes have been introduced overseas.

27. The Group is of the view that the housing market impacts are unlikely to be large, but it may be expected that rents will rise over time, and house prices will be lower, relative to the status quo. However, the Group's view is that tax has not played a large role in the current state of New Zealand's housing market, and will be unlikely to play a large role in fixing it. The potential effects on housing affordability are commented on more fully in Chapter 8.

11 Practical concerns reflected in double tax agreements will preclude New Zealand from imposing taxation on realised gains of non-residents other than ones from land-based industries. This is discussed further in the chapter.

28. If the Government ultimately does seek to increase the taxation of the residential property sector in whatever form, rents should be monitored. The Group's view is that the Government could consider using some of the revenue to mitigate the impact on renters (increased accommodation supplements for low income earners for example).

Integrity, base protection, and the treatment of income

29. The current approach means that some types of income are tax-favoured over others. There are also opportunities for tax minimisation and avoidance. Some of the challenges include:

    - **Incentives to classify on capital account.** Current rules provide an incentive to argue that any gain of a person is on capital account and not taxable. For example, in business asset sales, some of the assets are on capital account (e.g. most land and goodwill), while others are on revenue account (e.g. trading stock). Since gains on capital account assets are not taxed, the vendor has an incentive to allocate more of the selling price to capital account assets.

    - **Incentives for some forms of labour income to end up as tax-free capital gains.** Anecdotal evidence suggests that some people spend considerable part of the time refurbishing rental houses that are then sold for a capital gain. In effect this is labour income that, when reflected in a higher sale price, becomes tax free. This will remain an issue for owner occupied houses, which are to be excluded from either a tax of realised capital gains or a risk-free return method tax.

30. A more consistent approach to the taxation of capital income could reduce opportunities for tax minimisation such as dividend avoidance or trust streaming - discussed in the Integrity chapter (chapter 15). It could also reduce or eliminate charging provisions that rely on the hard to establish intention or purpose of the taxpayer, and therefore enhance the integrity of both assessing and administering the law. This should in turn improve the perception of fairness of the tax system and improve social capital.

31. However, the extent to which it does so in practice will depend heavily on the details of policy design, including avoidance provisions. In general, design choices that reduce the distinction between capital gains and other forms of income should increase the integrity of the tax system. However, this could be at the cost of creating distortions elsewhere and so it is not always possible to arrive at this ideal position in the course of policy design.

Legislative design, administration and compliance

32. The Group recognises that extending the taxation of capital income could result in the simplification of some aspects of the existing tax rules. For example, the following provisions might be able to be able to be repealed or reformed:

    - Land sales (and the bright-line rules).
    - Profit-making undertaking or schemes.
    - The grant, renewal or transfer of leasehold estates and licenses.
    - Sales of patent rights.
    - Some types of intellectual property.

33. However, in their place it will be necessary to have rules relating to the excluded family home, rules limiting deductions for expenses on second homes, and roll-over relief that might affect commercial, industrial and farmland sales. In the design of rules extending the taxation of capital income the Group is seeking to balance extra compliance and administrative costs and the benefits from such a widening of the tax base.

34. Overall, the Group acknowledges that the extension of capital income taxation will significantly increase compliance and administration costs. The Tax Review 2001 (known as the McLeod Review) noted that capital gains tax regimes tend to be one of the most complex areas of tax law in the jurisdictions that have capital gains taxes. Moreover, unlike most other complex areas of tax law, the capital gains rules must be interpreted and applied by 'ordinary' taxpayers. On the other hand, virtually every other country in the OECD has been able to successfully deal with extending their tax base in this way.

35. We have not yet undertaken a detailed estimate of the compliance costs of extending the income tax base. Such costs would be significant but dependent on the design details.

36. Similarly, we would expect the extension of the taxation of capital income to put additional demands on Inland Revenue in terms of tax assessment, advice, collection and enforcement. For any extension to be implemented successfully the government will need to resource Inland Revenue in all of those areas.

Revenue effects – Comprehensive income taxation and the risk-free return method

37. There are two ways of taxing capital income that have similar economic effects. Those two ways are taxing the full economic income from an asset, including revenue flows but also accruing capital gains. The alternative is not to tax the revenue or any gain but to tax instead an imputed risk-free return. This alternative is the essence of the risk-free return method of taxation. However, we note that whereas taxing full economic income taxes economic rents, the risk-free return method does not.

38. Generally, risky assets will earn a premium to compensate for risk. Taxing a risk-free return instead of an actual risky return might collect less revenue on average, but the revenue it does collect will itself be less risky.

39. As an example, revenue from a risk-free return method will never be negative, either in aggregate or for any individual taxpayer. This is the case even when there are capital losses in a failing real estate or share market. If the government wanted the higher return associated with more risky assets, it is free to use the revenue from risk-free revenue to invest in such risky assets and obtain the higher return.

40. Conversely taxing realised capital gains is broadly symmetrical. For example, a sale price (that might produce a net taxable gain) for one taxpayer will be the cost of that asset for another taxpayer. Also in a falling real estate or share market, there could be capital losses which can have a significant impact on revenue collections.

41. As a consequence of the above, a simple comparison of the revenues from extending the taxation of capital income by using the risk-free return method or by including more capital gains in the income tax base can be misleading. While it will always be expected that including more capital gains will raise more revenue in a mathematical sense, taxing a risk-free return will provide revenue that is more certain for Government, and therefore just as valuable as revenue from risky returns, even if the amount appears on its face to be smaller.

42. Although the risk-free return tax appears to generate less revenue on average than taxing realised gains, the cost of the two streams to taxpayers, and the benefit to Government, will therefore be similar in risk-adjusted terms. Whether capital gains or losses will be realised over a future period is dependent on many factors: a shortage of land supply and low interest rates have produced increasing land values over recent years; economic shocks have also led to significant losses in share values in the past.

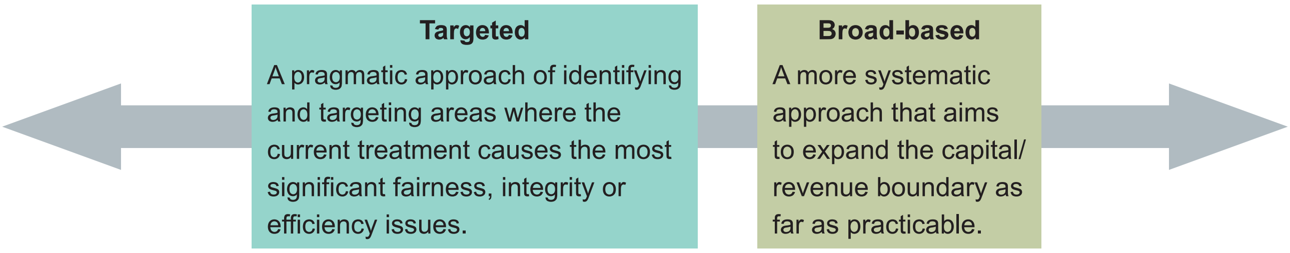
Options for extending the taxation of capital income

43. Having regard to the policy considerations referred to above, the Group has considered the merits of two options for extending the taxation of capital income. As mentioned, these are extending the taxation of realised capital gains from specific assets not already taxed and taxing certain capital assets on a deemed return basis, referred to a risk-free return method. We first consider the design principles that might apply to extending the taxation of realised capital gains and then consider the risk-free return method.

44. The Group is aware that any recommendations it ultimately makes in respect of extending the taxation of capital income could have significant impacts for assets held by Māori in collective ownership - such as Māori freehold land and assets held by post settlement governance entities. This chapter does not discuss these impacts in detail. However, the Group intends to use the period between the interim and final reports to better understand this asset base and explore potential implications with Māori stakeholders.

Extending the tax net – realised gains

45. The main choice with regard to taxing capital gains is how far to extend the existing tax net. There is a spectrum of options under two broad approaches:



46. Under a **targeted approach**, gains on some assets would be brought into the tax net on the basis that they are relatively easy to tax, and that including these assets will go a substantial way towards addressing the challenges we currently face. Whilst some countries have had comprehensive capital gains tax regimes in place for over fifty years, to date New Zealand has adopted a targeted approach, taxing capital gains on only certain assets (some land sales, gains from financial arrangements, for example).

47. A targeted approach does have its downsides. The most significant problem is that the inconsistent treatment of those assets remaining untaxed will reduce horizontal equity compared with a broad approach, and distort investment choices. There will also be continuing integrity challenges as taxpayers seek to categorise gains as tax free capital gains. (Examples of these under our current rules are allocating more of a business's sale proceeds to intellectual property and/or goodwill and less to trading stock and other revenue account assets.)

48. A **broad-based approach**, on the other hand, seeks to expand the capital/revenue boundary as far as practicable, including a wide scope of gains. A broad-based approach greatly improves the integrity and horizontal equity of the tax system, but also greatly increases the complexity of compliance and administration.

49. It is difficult to make this choice in the abstract. This is because the extent to which the costs and benefits of taxing capital gains are realised will depend not only on what is already taxed in New Zealand but also the detailed design choices adopted to tax the untaxed assets. It is therefore critical to develop concrete, worked-up proposals that can then can be assessed against each other.

50. The Group has adopted a targeted approach in developing design features to extend the taxation of capital gains in the sense that we have identified asset classes that are not presently fully taxed. However, when the extent of these changes is considered, together with the existing regimes taxing capital gains, the outcome will be a broad-based taxing of nearly all capital gains.[12]

51. The main design choices relate to what to tax, when to tax, and how to tax. A host of more detailed design issues then flow from these choices, and particularly from a decision to introduce a realisation-based tax and not a tax based on accrued gains. These concepts are explained below.

52. This section summarises the Group's initial thinking on the key design features of the proposed taxation of realised capital gains (again, further detail is in Appendix B). The Group will assess the impacts of these features over the coming months as it works towards its recommendations in the Final Report.

12 Owner occupied houses are excluded, as are some assets owned by non-residents as a result of practical concerns and our double tax agreements with other countries.

What to tax

53. Broadly, taxation would extend to include income from realisation of any of the following assets (generally those that give rise to gains that are not already subject to tax under existing taxing provisions):

    - interests in land (other than the family home). This includes all other residential property, commercial, agricultural, industrial and leasehold interests not currently taxed;
    - intangible property, including goodwill. The Group is still considering how widely this should be defined;
    - all other assets held by a business or for income producing purposes that are not already taxed on sale (such as plant and equipment);
    - shares in companies and other equity interests.

54. Taxpayers would be entitled to deduct their acquisition and improvement costs (to the extent that those costs have not already been depreciated) from the sale proceeds received on disposal, so only the net gain (or loss) would be taxable.

55. Taxation would not extend to gains realised from the disposal of certain assets, such as:

    - the family home and the land under it (referred to as an excluded home);
    - certain personal assets including cars, boats and other household durables, because these generally decline in value and represent private consumption; higher value personal assets such as jewellery, fine art and other collectibles (rare coins, vintage cars etc.) on the basis that whilst if they are investments they might appreciate in value, losses might equally represent private consumption.

56. Taxation would extend to some non-residents holding New Zealand land (or shares in land-rich companies) or business assets through a New Zealand branch. Taxation would not otherwise extend to non-residents. This is because it is not practical to, for example, tax a non-resident selling shares in a New Zealand company to another non-resident. This issue arises because New Zealand's double tax agreements with other countries limit New Zealand's ability to tax gains from the sale of other assets owned by non-residents who do not have a place of business in New Zealand.

57. Taxation would extend to assets realised after a specified 'effective date.' Assets already owned on the 'effective date' would need to be valued. Any appreciation in value accruing before the effective date would not be taxed while increases in value arising after the effective date would be taxable.

When to tax

58. The main options for taxing capital gains are to tax gains as they accrue (as their value appreciates, even if they aren't sold), or when they are realised.

Accrual-based tax

59. An accrual-based tax taxes the gain in an asset's value over a defined period (usually a year), with the tax payable at the end of each period. The tax liability will arise even if the asset is not disposed of during that period. Declines in asset value during that period are equally treated as a deductible loss, and offset against other income or carried forward.

60. There are some disadvantages associated with an accrual-based tax:

    - **Valuation challenges.** An accrual-based tax requires a valuation at the end of each period to identify the gain or loss. Valuations are readily available for widely-traded assets, but it is difficult to impartially value some types of assets (such as closely-held businesses). These valuation challenges will impose much higher compliance costs on the owners of certain types of assets. There are also timing risks associated with valuation. If valuation occurs on a specific date at the end of the taxable period, the owners of seldom-traded shares may be able to manipulate the value of their shares in order to reduce their tax liabilities.

- **Cash flow pressures.** An accrual-based tax can create cash flow pressures for the owners of assets that do not produce regular streams of cash income. Some owners may even have to dispose of their assets to meet the tax liabilities. The risk of forced disposal could discourage investment in assets with upfront expenses but longer-term returns.

- **Perceptions of unfairness.** An accrual-based tax taxes unrealised gains, which do not necessarily correspond with every person's understanding of income.

61. The practical challenges to the implementation of an accrual-based tax are substantial. Consequently, there has been little use of accrual-based taxes in practise by other countries and we do not support adopting one. The risk-free return method of taxing capital gains can be viewed as an accrual-based tax and the Group has considered it in respect only of certain asset classes (considered further below).

Realisation-based tax

62. Under this approach, the gain on assets is taxed only when the assets are sold. Conversely, any losses on the sale of the asset may be offset against other income or carried forward.

63. The primary concern with a realisation-based tax from an efficiency perspective is the issue of 'lock-in'. 'Lock-in' occurs when asset owners retain assets instead of selling them, in order to postpone or avoid realising gains and crystallising the tax liability. To remedy this concern and for important fairness concerns, jurisdictions overseas often provide 'rollover relief' to ensure that tax is deferred on what would otherwise be a realisation event.

64. As an example, if rollover relief is given for a 'similar asset' swap, a business that sells its existing premises and purchases a new premises does not pay tax on any gain in the value of its existing premises. Instead, the new premises takes the cost base of the initial premises so that if the new premises are later sold, the whole gain, including the gain from the initial premises, is taxed. The gain is said to have "rolled over" from the initial sale.

65. Rollover relief removes the disincentive to sell that can be created by a realisation-based tax. While that may have the attractive feature of reducing lock-in in some cases, there are balancing concerns with extensive rollover relief that suggest caution.

66. Roll-over will reduce the revenue raised and can increase lock-in when assets have been held for a long time. This is because the cost base will be far lower, and the potential tax liability far higher, than if tax had been paid every time there was a sale.

67. Moreover, because some rollover reliefs are optional, taxpayers are likely to use them when assets have appreciated, but not when assets have depreciated. This asymmetry creates its own revenue integrity and efficiency concerns. Therefore, the more extensive the rollover relief, the greater the case for only allowing capital losses to be deductible against capital gains (known as 'loss ring-fencing').

68. As a general rule it is proposed that capital losses would be able to be utilised against ordinary income. However, for base integrity reasons, in some cases capital losses would be ring fenced (only able to be carried forward against future capital gains from similar asset classes).

69. Loss ring-fencing, however, reduces the risk-sharing and risk neutrality benefits of the tax by taxing gains but restricting deductions for losses. Currently, when assets held on revenue account are sold, if there is a gain the government collects a portion of that gain as tax. If there is a loss, it can be offset against other income meaning that the government gives back a portion of that loss as a tax reduction on other income. This means that the Government shares in the risk of the investment.

70. Taxing capital gains and allowing a deduction for losses would extend this to assets held on capital account. Ring-fencing, however, will remove some of these benefits of risk sharing with the government. It will also increase compliance and administration costs, as losses must be ring-fenced to the extent they are 'capital' losses instead of 'revenue' losses.

71. This suggests a direct trade-off between the amount of rollover relief provided, and the distortions and compliance costs introduced from loss ring-fencing. In Appendix B, the Group has commented on the impact of the range of roll-over relief circumstances from a reasonably restrictive approach to a broad approach, and the follow-on consequences from each approach.

How to tax

72. As this approach does not impose a new type of tax but significantly expands the capital/revenue boundary, taxation would generally be calculated and collected in the same way as currently applies for disposals of revenue account property — i.e. taxation would apply at ordinary income tax rates to nominal gains and losses. Costs would generally be deducted at the time of sale so as to arrive at the net capital gain.

73. The Group is also considering some practical modifications, such as withholding taxes, which could improve collections but might not necessarily reduce compliance costs. The workability of withholding taxes is yet to be tested but we recognise that extending the taxation of capital gains will materially increase compliance costs even though we are trying to minimise this in our design of the rules. We have no doubt that altering the existing rules in the manner canvassed in Appendix B will increase the complexity of tax compliance for all taxpayers affected by it.

Interaction with other regimes

74. Appendix B outlines how the Group envisages the extension of tax would interact with the existing tax rules for companies (including controlled foreign companies (CFCs) and corporate groups), partnerships and look-through companies, trusts, Māori entities and with social assistance programmes.

75. Consequential changes to KiwiSaver and other portfolio investment entities (PIEs), and foreign investment fund (FIF) regimes will also need to be considered. In addition changes to the taxation of farming livestock adopted by farmers will need to be considered.

76. All of these issues are complex and will require industry and stakeholder consultation.

Risk-free rate of return (RFRM) method

77. As mentioned, another approach for taxing capital gains is the risk-free return method taxation of some asset classes. The risk-free return method is an ex ante method of taxing economic income. Under the risk-free return method, the total income generated by an asset is calculated by applying a risk-free rate to the equity held by the owner in the asset (being the value of the asset net of any borrowings used to buy the asset); the result is then taxed at the taxpayer's marginal rate. As is discussed in the McLeod Review, the aim is to levy a tax which has a similar cost to taxpayers and benefit to the government to taxing full economic income. If the risk-free return rate is set accurately, the tax should not result in taxpayers either overinvesting or underinvesting in the type of asset.

78. The McLeod Review suggested using a real risk-free rate. A real risk free rate would be calculated by taking the rate applying to a "risk free" government bond rate and reducing that rate for the return on the bond that represented compensation for inflation. (For example, suppose the yield on a 2-year government bond is 1.8% and deducted from that would be the rate of inflation. If inflation is 1%, the real risk free rate is 0.8%.) The Group's view is that, in the current low-inflationary environment, and as inflationary gains are taxed on other forms of income it might be more appropriate to use a risk-free nominal rate for estimating a comparable return. In the above example the nominal rate is 1.8%.

79. The risk-free return method would replace the existing taxation of income for the assets subject to the risk-free return method. In other words, the income that is actually earned from the asset, and the expenses associated with earning that income, will both be ignored for tax purposes. Thus, in relation to residential property investments, for example, rental revenue would not be taxable income – but interest, repairs, and maintenance would not be tax deductible either. The risk-free return rate would be multiplied against a market value of the net equity in the

property each income year and that amount would be included in the taxpayer's taxable income for that year (and would be taxed at the taxpayer's marginal rate).

80. The risk-free return method can potentially be applied to any asset for which a verifiable and independent estimate of the net equity held in the asset is available each year. The main advantages of the risk-free return method are that:

 - the tax is not due on realisation, so there is no 'lock-in';
 - the tax is not as sensitive to the need for an accurate valuation as it is for an accrued capital gains tax;
 - it is a simple tax to apply (i.e. it meets the simplicity objective of an effective tax system); and
 - it provides more certain cash flows for Government.

81. The difficulties to be considered under a risk-free return method regime include the following:

 - establishing market values for the asset class in off-market situations and to a lesser extent establishing riskless rates;
 - integrating the risk-free return method with a tax system that gives interest deductions generally, as is the case under our present tax system;
 - integrating the risk-free return method with dividend imputation;
 - integrating the risk-free return method with foreign tax credits;
 - imposing the risk-free return method on unrealised gains with consequential cash flow difficulties.

82. The risk-free return method applies most cleanly to simple portfolio investments. Since the idea of a risk-free return method tax was first proposed by the McLeod Review 2001, there has been considerable progress in addressing inconsistent tax treatments originally highlighted by that review. Interests in listed foreign entities are now taxed by the FDR method and domestic saving vehicles are taxed by the PIE regime. These changes have reduced the previous disparities in how domestic shares were taxed to individuals and funds. The FDR rate of 5% was set taking into account the nominal risk free rate at that time but also a dividend rate reasonably obtainable on foreign shares at that time. The PIE regime is a transparent regime subject to a single and final tax rate.

83. That leaves real property. Real property can be considered in two broad categories: residential property (other than the family home) and other 'active' business premises, such as commercial, industrial, or farm property.

84. With commercial and industrial property, some commentators consider that risk-free return method tax will face the problems that arise from the bundling of the owner's labour income and the existence of economic rents. Other commentators consider that these are both factored into the market value of the asset and are accordingly captured into the tax net (RFRM is applied to market values each year).

85. In any event one significant difficulty with all land types is measuring net equity (identifying debt that relates to the property as distinct from the business in which they might be employed). Another difficulty (also significant) is determining market values each year. It is likely preferable to tax commercial, industrial and farm land (and connected business activity) on their income instead, in which case it would be unnecessarily complex to apply an RFRM tax on those classes of land. If gains on commercial, industrial, and farm property are seen as a gap in the tax system, a more neutral way of taxing these gains is likely to be through a tax on realised capital gains.

86. The Group will consider the potential for a risk-free return method tax on residential property other than a principal residence, such as second homes and baches. However, similar disadvantages to those described above would also apply (annual market values and measuring net equity, albeit to a lesser extent). Further, residential property not producing any income (second homes, baches) would not generate cash flow to meet the annual tax liability.

87. A key issue with taxing on a risk-free basis relates to its public acceptability. A risk-free return method taxes a risk-free return, rather than the actual income generated by an asset. This may not correspond closely with public perceptions of what constitutes income. As mentioned, the tax will also create cash flow pressure for the owners of assets that do not generate regular streams of cash income. Some owners may have to dispose of assets to meet their tax liabilities.

Revenue

Revenue from taxing gains on realisation

88. The Government currently relies on a relatively narrow base of tax types. Revenue is predominantly collected from the following three tax types: personal income tax, corporate income tax and GST.

89. Looking out to the future there are potential threats to these taxes due to macro trends such as the rise of the contractor, robotic and AI technologies, globalisation and the digital economy. It is difficult to predict what these trends could mean for future tax revenues if the status quo is maintained. An extension of capital income taxation will broaden the base of the tax system and help safeguard the Government's future revenue collection ability. The additional revenue could be used to increase the Government's flexibility for dealing with future challenges, or pay for other revenue-reducing reforms.

90. The revenue impact of capital gains taxation will depend on the design of the tax, as well as behavioural responses and movements in asset prices. The Group asked officials to model revenue from a tax that applies to gains on all types of land (excluding the family home) and domestic shares on realisation.[13] Assuming annual appreciation of 3% across all types of assets, the tax is modelled to raise almost $6 billion.[14]

91. The revenue from taxing capital gains on realisation will be volatile, complicating fiscal management. Tax revenue will increase as asset prices rise, and reduce as asset prices fall.

92. Ignoring volatility, the following table estimates the revenue from taxing capital gains on realisation. Again, it is stressed that these results are heavily design and detail dependent. The more exemptions are introduced (including roll over relief) the lower the likely revenue. In addition, if some expenses become deductible that have not previously been deductible (seismic strengthening costs, weathertightness remedial costs, building depreciation) then revenue may be materially reduced in the short term. None of the above are factored into these estimates (see Table 6.2).

Table 6.2: Projected revenue from taxing capital gains on realisation

Tax revenue ($m)	Year 1 2021/22	Year 2 2022/23	Year 3 2023/24	Year 4 2024/25	Year 5 2025/26	Year 6 2026/27	Year 7 2027/28	Year 8 2028/29	Year 9 2029/30	Year 10 2030/31
All residential land, excluding the family home	50	170	330	530	770	1,020	1,300	1,600	1,910	2,240
Commercial, industrial and other land	50	120	230	360	520	690	900	1,120	1,360	1,620
Rural land	30	70	140	220	310	400	510	610	730	840
Domestic shares	160	500	1,030	1,060	1,090	1,120	1,160	1,190	1,230	1,260
Total	**290**	**860**	**1,730**	**2,170**	**2,690**	**3,230**	**3,870**	**4,520**	**5,220**	**5,960**

These estimates are preliminary and presented for indicative purposes only.

13 In this context, and in the tables, "land" refers to land and improvements, such as buildings.

14 Further details of the assumptions and risks for these projections are set out in Appendix A.

93. There is also the question of what to do with the treatment of foreign (non-New Zealand and non-Australian) shares. Currently, these are taxed on a deemed return of 5% of the opening value of the shares, regardless of the actual return in dividends and realised capital gains[15]. It is similar to the risk-free return method in taxing on a deemed return basis, but the rate used is high compared to the risk-free rate that is considered to be efficient and neutral as a deemed rate for tax purposes. It is also calculated on the gross asset value and interest is allowable as a deduction.

94. Table 6.3 estimates the additional revenue from replacing FDR with a system of taxing capital gains. For the purposes of the costing, foreign shares are assumed to appreciate at 5% per year and have a 2.4% annual dividend yield (the 20-year average for the Morgan-Stanley Capital Index). The costings are dependent on assumptions of future equity yields and estimated average holding period of shares. This revenue is in addition to the revenue above.

95. Again, it should be noted that the mere fact that revenue is expected to be larger under a tax on dividends plus capital gains does not necessarily mean that the revenue should be seen as more valuable by the government. The additional revenue stream would also be more risky.[16]

Land taxes[17]

96. A land tax is a form of wealth tax that imposes an annual tax liability on the unimproved value of land. It represents a uniform increase in taxation on landowners based on the unimproved value of their land, rather than an increase based on expected capital gains. A land tax is a new tax base. It is not a substitute for an income tax, but could apply in addition to the income tax if it had merit.

Is there a case to introduce a land tax?

97. Broad-based land taxes are generally considered to be an efficient means to raise revenue: the supply of land is fixed and therefore unaffected by economic incentives such as taxation.[18] Land taxes are simple to administer and difficult to avoid.

98. A land tax will provide the Government with a less volatile revenue stream than, say, a capital gains tax on real property. Tax will still be collected in years when asset values fall and actual economic income is negative. From a long-term revenue perspective, land is also a desirable base because it is immobile.

99. Yet there are some major disadvantages associated with land taxes:

- Land taxes can be criticised on horizontal equity grounds because they apply to only one type of asset. A land tax will have a disproportionate impact on certain groups and industries that hold a greater share of their wealth in land.

Table 6.3: Projected revenue from replacing FDR with a tax on realised gains for foreign shares

Tax revenue ($m)	Year 1 2021/22	Year 2 2022/23	Year 3 2023/24	Year 4 2024/25	Year 5 2025/26	Year 6 2026/27	Year 7 2027/28	Year 8 2028/29	Year 9 2029/30	Year 10 2030/31
Fiscal impact of replacing FDR with tax on realised gains	(170)	140	480	500	530	560	580	610	640	680

These estimates are preliminary and presented for indicative purposes only.

15 The full regime has further complications, including a de minimis and some special rules for individuals, but those are not relevant for current purposes.

16 While there are methods of discounting risky cashflows to be able to compare directly with risk-less cashflows, selecting the appropriate risky rate to use is difficult when contemplating taxpayers (including individuals, public, and private companies) as a whole.

17 In this section, land refers solely to surface land and does not refer to buildings and improvements.

18 A land tax that excludes owner-occupied homes will be less efficient than a broad-based land tax.

- The cost of the tax will fall entirely on the owners of land at the time of introduction. Some of these owners will be wealthy, but others will not be; a land tax does not distinguish between levels of wealth. A land tax could potentially mean that property owners that are heavily geared end up with negative equity in their property.

- A land tax will create cash flow pressures for the owners of assets that do not generate regular streams of cash income. Some owners may even have to dispose of assets to meet their tax liabilities.

100. Moreover, a general tax on land has been ruled out by the terms of reference. If land associated with a principal residence is exempt, the tax would not have the economic efficiency benefits of a general tax on land.

101. The Group also acknowledges the strong opposition expressed by Māori stakeholders towards land taxes. Māori submitters argued that Māori would be disproportionately affected by a land tax, and raised concerns about the potential for a land tax to destroy Māori wealth and alienate Māori from their land.

102. A land tax will have complex impacts on the housing market. For a land tax that excludes owner-occupied housing, land prices will fall, but by less than would be the case for a perfectly broad land tax. Some of the tax will also be paid through higher rents for non-owner occupied uses of land.

Overall assessment

103. The Group acknowledges that a land tax is a conceptually efficient tax. Nevertheless, the Group is concerned about the social acceptability of a land tax in a New Zealand context – particularly since any land tax will apply in addition to local government rates which are substantially a tax on land. The Group has decided not to recommend a land tax.

Wealth taxes

104. Wealth taxes are not strictly taxes on capital income, but they are another means of approaching the issue of capital taxation. Wealth taxes are levied on the value of a taxpayer's assets, and assessed periodically (usually on an annual basis).

105. New Zealand historically had wealth taxes – in the form of a land tax, an estate duty, and gift duties. All of these taxes have since been repealed. There has also been an international trend toward the declining use of net wealth taxes.

106. Many submitters have argued for the introduction of a wealth tax in order to reduce wealth inequality in New Zealand. A wealth tax would reduce the assets of wealthier households, and provide revenue for redistribution to poorer households. There are, however, a number of disadvantages associated with wealth taxes:

    - In order to operate efficiently a wealth tax should apply to all forms of wealth, and should be based on accurate valuations. In practice, wealth taxes tend to have significant exemptions and simplified valuation rules, which can create major distortions to saving and investment decisions (OECD 2018).

    - Wealth taxes tend to suffer from high levels of evasion and avoidance. Taxpayers are likely to bias their savings towards untaxed assets, and may even emigrate in order to avoid the tax. As a result, wealth taxes often do not produced the intended redistributive effects (OECD 2018).

    - Wealth taxes are difficult to apply. Certain types of assets are hard to value and may even lack a market price. They therefore suffer from many of the same drawbacks as taxing capital gains on accrual. Wealth taxes tend to be costly to administer relative to the amount of revenue they raise (OECD 2018).

107. Wealth taxes are usually applied in addition to an income tax on capital income, in which case they do not reduce any existing distortions caused by the income tax, but rather generate an additional set of distortions.

108. The Group acknowledges that there are real issues in the tax system relating to the taxation of capital income (and, in particular, the taxation of capital gains). A wealth tax, however, is a complex form of taxation that is likely to reduce the integrity of the tax system.

Next steps

6.1 The Group is still forming its views on the best approach towards extending the taxation of capital income. Only once such an extension is designed can a meaningful comparison take place between the options and the status quo. Appendix B sets out the Group's initial thinking on further design features of broad-based taxation of capital income. The Group will work toward its ultimate recommendations in the Final Report.

7

Retirement savings

1. Individuals save for a variety of reasons. They might be saving up for a big purchase, or setting aside money to deal with emergencies; they might want to build a nest egg for their retirement, or they may be saving for their children. In each case, these individuals are sacrificing a certain amount of comfort in the present to secure higher living standards in the future – whether that be for them or their descendants.
2. The effects of saving are not limited to individuals. The saving and investment choices of firms, individuals, and the Government – aggregated across the economy – shape the accumulation of financial and physical capital in New Zealand. Rates of private saving therefore have broader impacts on the performance of the New Zealand economy.
3. While there are many reasons for individuals to save, one of the primary motivations is the need to ensure an adequate standard of living in retirement. Previous chapters have dealt with the taxation of capital and wealth more broadly; this chapter focuses on the tax treatment of retirement savings in particular.

Box 7.1: A note on saving and investment

Saving is the difference between income and consumption. Individuals, households, and firms save (private saving), and governments save also (public saving); the sum of private and public saving is national saving. Saving results in an accumulation of wealth, which may be invested.

Investment is the purchase or creation of a capital asset that is used to generate a return. New Zealanders can invest in assets in New Zealand and overseas, and the total return on investments owned by New Zealanders is part of national income.

Non-residents also make investments in New Zealand. Non-resident investment in New Zealand is significant, and makes up for the shortfall in national saving. Still, a higher level of national saving would probably result in additional investment in New Zealand, because local investors are more likely to be aware of local investment needs or opportunities than non-residents, and because local investors may better understand the risks of investing in New Zealand.

Income from non-resident investment flows to the non-resident investors. However, non-resident investment is still valuable to New Zealanders because it provides opportunities for local employment, which increases national income and enhances human and social capital.

Goals and interests

Retirement income policy objectives

4. The overall objective of retirement income policy is to minimise economic insecurity in old age. New Zealand achieves this objective through three main tools:

    - New Zealand Superannuation alleviates the risk of old age poverty by providing a universal benefit to all New Zealand citizens and residents 65 and over (subject to some residency restrictions).
    - The KiwiSaver scheme supports private saving to maintain a standard of living in retirement over and above the level guaranteed by New Zealand Superannuation.
    - Private decision-making on retirement saving is supported by measures to improve the financial literacy of New Zealanders.

5. There is some evidence to suggest that most New Zealanders are saving enough to provide an 'adequate' income in retirement. However, this judgement is conditional on the assumption that future generations remain eligible for New Zealand Superannuation under existing policy settings. This condition may not hold if long-term fiscal pressures require change to the scheme. Falling rates of homeownership will also affect the adequacy of savings for retirement.

Broader policy objectives

6. Retirement savings can also be conceived as a tool to pursue a broader set of policy goals:

- **Macroeconomic stability.** Higher national saving will reduce New Zealand's external indebtedness and current account deficits, and bolster New Zealand's resilience to economic shocks.
- **Investment, productivity and growth.** Higher saving rates could, in principle, reduce the cost of capital and increase incentives to invest. Higher national saving could also support export growth by reducing pressure on interest rates and exchange rates. Savings policy may also affect the allocation of investment, for example by reducing distortions in the treatment of different asset classes.
- **Capital markets development.** A greater pool of domestic savings could deepen domestic capital markets and enhance the ability of local firms to secure capital to grow.

7. One of the challenges for policymakers is to balance these multiple objectives against the core goal of ensuring retirement income adequacy.

Current tax treatment

8. There are three main features of New Zealand's taxation of retirement savings:

The TTE system for taxing capital income

9. New Zealand generally taxes capital income, including retirement savings, on a 'Taxed – Taxed – Exempt' (or 'TTE') basis. Investments are made from taxed income; the income earned from the investment is taxed; but amounts withdrawn from the investment are not taxed. Since capital gains are not generally taxed, investments earning significant capital gains are taxed on a 'Taxed – Partially Taxed – Exempt' (or 'TtE') basis.

10. This approach is to taxing retirement savings is highly unusual among OECD countries. Most OECD countries tax some retirement savings on an 'Exempt – Exempt – Taxed' (or EET)' basis (Yoo and de Serres 2005). Other capital income is usually taxed on a 'TTE' basis.

Owner-occupied housing

11. Imputed income from owner-occupied housing is not taxed. Retirement savings in the form of owner-occupied housing are therefore taxed on a 'Taxed – Exempt – Exempt' (or 'TEE') basis.

The Portfolio Investment Entity (PIE) regime

12. The PIE regime began in 2007 and aims to remove tax barriers to investing in managed funds, such as KiwiSaver funds. Gains on shares held by PIEs are not taxable. This treatment is a response to the fact that gains on shares held by individuals are, in practice, rarely taxable – whereas gains on shares held by managed funds were almost always taxable as business profits.

13. Taxing PIEs on share gains would have continued a bias against the use of managed funds for equity investment, so managed funds operating as PIEs are exempt from taxation on the sale of New Zealand and Australian shares. Gains on the sale of other foreign shares are also generally not taxed, and instead are taxed on a deemed return basis (the Fair Dividend Rate, or FDR method). Other capital gains (such as on land) are subject to the general provisions of the Income Tax Act. In addition, traditional managed funds and unit trusts (taxed as multi rate PIEs) are required to attribute all income to investors (often on a daily basis) and then apply each investor's tax rates to that income. Removing the tax on share gains made this simpler.

14. The PIE regime has more generous rates than the income tax regime. The maximum PIE rate is 28%, and there are generous rules for investors on lower rates as well. The rules allow investors to choose a rate that is equivalent to their personal marginal tax rate based on their taxable income alone (i.e. excluding amounts earned in PIEs). A separate threshold, based on taxable plus PIE income, limits the extent to which individuals can benefit from the lower PIE rates.

15. The full schedule of PIE rates is outlined in Table 7.1 below.

16. For most investors, it is the lower rate schedule – rather than the treatment of shares – that is the main benefit of PIE taxation.

The KiwiSaver scheme

17. KiwiSaver is a voluntary saving scheme that aims to encourage retirement saving by individuals. KiwiSaver funds are locked into the scheme until the individual reaches the age of 65, although early withdrawals may be made for first home purchases and cases of hardship. Individuals are automatically enrolled into KiwiSaver when they start a new job, and must choose actively to opt out of the scheme.

18. KiwiSaver accounts are taxed under the PIE regime. KiwiSaver also provides other Government incentives, although the generosity of the incentives has reduced over time. KiwiSaver members benefit from an annual member tax credit of up to $521.43, paid at a rate of 50 cents for every dollar of member contribution. Employers are required to make a matching contribution of 3% of the individual's salary.

The treatment of inflation

19. Ideally, the marginal effective tax rates on different investments should be as equal as possible, so that the tax system does not bias taxpayers towards otherwise unproductive investments. In this regard, inflation is a source of distortion, because tax is calculated on nominal income, and inflation has different effects on various asset classes.

Table 7.1: Schedule of PIE rates

Marginal tax rate	Individual tax rates – for the current year	PIE Tax Rates – For either of the two prior years:	
	Taxable Income	Taxable Income	Taxable + PIE Income
10.5%	<=$14,000	<=$14,000 AND	<=$48,000
17.5%	$14,001 - $48,000	<=$48,000 AND	<=$70,000
28%	NA	>$48,000 OR	>$70,000
30%	$48,001 - $70,000	NA	NA
33%	>$70,000	NA	NA

20. In particular, inflation raises the real effective tax rate on debt investments. Higher effective tax rates reduce the rate of accumulation of savings. As an example, for a statutory tax rate of 33%, if the real interest rate is 3%, and inflation is 2%, then the real effective tax rate is 55%. Effective tax rates, using the PIE rates, are shown in Table 7.2 below.

21. Although inflation is currently low, nominal interest rates are also low; this has made inflation a larger component of the nominal interest rate and therefore increased the real effective tax rate on debt.

22. These concerns about inflation and investment biases are, in principle, a reason for considering the comprehensive indexation of the tax base (rather than just in the context of retirement saving).

23. Taxing interest income on a nominal basis can have a significant impact on the accumulation of retirement savings. However, for many savers, this impact is offset by the other benefits of investing in KiwiSaver.

24. Take the example of a KiwiSaver investor earning $48,000 *per annum*. The investor saves at an annual contribution rate of 3% (plus the 3% employer contribution). The investor's KiwiSaver account consists only of debt investments; the account earns a nominal return of 5% and a real return of 3%. If real interest income were taxed instead of nominal interest income, the investor would accumulate 6% more savings after 30 years. However, the member tax credit *already* provides the investor with the benefit of having 19% more in accumulated savings after 30 years.

25. The member tax credit will offset the impact of taxing nominal interest income for KiwiSaver members earning up to approximately $100,000 *per annum*[19]. Beyond annual income of $100,000, the member tax credit will only partially offset the impact of taxing nominal interest income.

International comparisons

26. OECD countries tend to offer generous incentives for retirement saving. Most OECD countries also apply an 'Exempt – Exempt – Taxed' (or 'EET') approach (Yoo and de Serres 2005). This means that retirement savings contributions are made out of income that is not taxed, and the investment income is not taxed as it is earned. Instead, the capital and accumulated earnings are taxed at the point of withdrawal.

27. New Zealand, in contrast, offers limited concessions for retirement saving. In fact, among OECD countries, New Zealand has the lowest tax subsidy for retirement savings relative to its general system for taxing investment income (Yoo and de Serres 2005). However, for members earning up to approximately $48,000 per year, the annual member tax credit provides more benefit than EET would, although higher income savers would benefit more from EET.[20]

Table 7.2: The future value of $1,000 invested today after 30 years

	No tax	Tax real income		Tax nominal income	
		17.5%	28%	17.5%	28%
Future value of $1000 in 30 years	$4,322	$3,719	$3,396	$3,362	$2,889
Effective tax rate on nominal income	N/A	10.5%	16.8%	17.5%	28%
Effective tax rate on real income (after taking account of inflation)	N/A	17.5%	28%	29.2%	46.7%

Note: This table assumes a nominal interest rate of 5% p.a. and inflation of 2% p.a.

19 This assumes that a KiwiSaver member contributes 3% of their salary, and the employer pays a 3% match, and the KiwiSaver account earns a 5% annual return.

20 Ibid.

Policy considerations

28. In light of this context, the Group has considered whether there is a case to introduce additional concessions for retirement saving. There are two important considerations in making this judgement:

National saving impacts

29. When considering measures to increase retirement saving, it is important to distinguish between national saving, public saving, and private saving. Private saving benefits individuals, but there can be offsets between public and private saving. The macroeconomic benefits of saving will only be realised if there is an overall increase in national saving.

30. This means policymakers need to think carefully about the impacts of tax reform on both public *and* private saving. International evidence suggests that tax incentives may not generate additional saving if individuals simply reallocate their existing savings into the tax-favoured vehicle (Gravelle, 1994; OECD, 2007).

31. At the same time, tax concessions can have significant fiscal costs – which, all else equal, will reduce public saving. The offset between public and private saving means that a poorly-designed regime, which only slightly increases private saving and significantly reduces public saving, might actually have a net negative impact on national saving.

32. A key question in assessing tax concessions is therefore the extent to which the increase in private saving arising from the concession will outweigh any consequent reduction in public saving.

Distributional impacts

33. There is a strong life-cycle pattern to retirement saving. Individuals save during their working lives and spend down their savings in retirement; saving rates also generally increase later in an individual's working life.

34. Higher-income households save more than lower-income households, even when considering only households where the highest income earner is between 30 and 60 years old (Figure 7.1). Saving patterns also differ by gender. Women's adult lives often involve periods outside the paid workforce or in part time employment, which can result in lower government contributions to KiwiSaver and lower KiwiSaver balances than would otherwise be the case.[21]

35. Low-income earners may have access to greater household savings if they are part of high-income households. Low-income households, on the other hand, tend to have very low or negative levels of savings.

36. Given the skewed distribution of saving, untargeted tax concessions for retirement saving tend to be regressive.

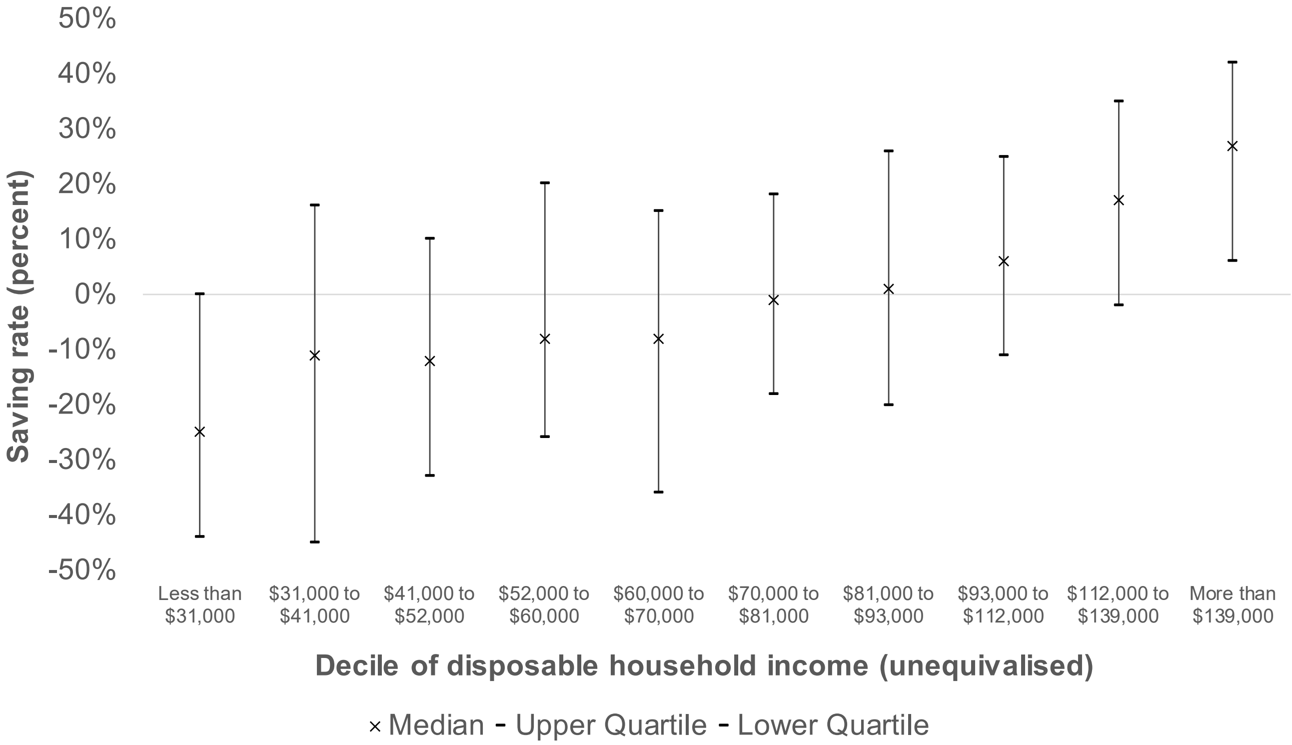
Implications for policy design

37. The major risks with saving concessions are that they can be expensive and regressive. The most common approach to managing these fiscal and distributional impacts is to impose tight restrictions on the amount of contributions into tax-favoured accounts. The trade-off this presents is that tight limits may reduce the amount of additional private saving generated by the concessions.

38. KiwiSaver has a greater proportionate benefit for lower-income savers. The main benefit is the member tax credit; all members saving more than $1,042 per year will receive the credit, but it has a proportionately greater impact on lower-income savers.

21 The Group notes, however, that women also tend to receive New Zealand Superannuation for a longer period than men because of average life expectancy for women is higher.

Figure 7.1: Savings rate quartiles by income decile (for households with the highest income earner aged between 30 and 60 years old), 2012/13[22]



Source: The Treasury

Options

39. The Group has considered a range of options for encouraging greater saving through the KiwiSaver scheme:

- **Member tax credit** – an increase in the member tax credit from $0.50 per dollar to $1.00 per dollar.
- **Employer superannuation contribution tax (ESCT)** – the removal of ESCT from all employer matching contributions, or the removal of ESCT from contributions for employees earning up to $48,000 *per annum*.
- **KiwiSaver PIE rates** – reductions of five percentage points for each of the lower PIE rates (leaving the top PIE rate unchanged).
- **Changes to the structure of KiwiSaver taxation** – through the introduction of 'TEE' or 'EET' taxation for savings in KiwiSaver schemes.

40. The options have quite different impacts in terms of private savings and fiscal cost (see Table 7.3).

41. As is evident from the table, some of the options are both expensive and regressive, whereas other options are cheaper and have a greater impact on saving by low- and middle-income earners. Furthermore, saving by these groups of people is more likely to be 'new' saving than a reallocation of existing saving.

Assessment

42. The Group believes there is a case to consider additional concessions for retirement saving. Concessional treatment will make some allowance for the impact of inflation on long-term savings. Additional saving will improve the living standards of individuals in retirement. There are also likely to be broader economic benefits if there is an increase in the rate of national saving.

22 The distributions presented in Figure 7.1 only include households from the Household Economic Survey (HES) sample where the highest income earner in the household is between 30 and 60 years old, and where their data has not been excluded on the grounds of a number of outlier checks. Given these restrictions to a sub-sample of HES, results depicted will not be comparable to a similar analysis based on the entire HES sample.

Table 7.3: Options impact analysis

Option	% change in accumulated net savings after 30 years by annual salary			Annual fiscal cost for 2021/22 income year
	$48,000	$100,000	$200,000	
Increase member tax credit from $0.50 per dollar to dollar per dollar	+16%	+9%	+5%	$960 million
Remove ESCT for employees earning up to $48,000 per year	+8%	0%	0%	$180 million
Remove ESCT for all employer matching contributions	+8%	+18%	+19%	$740 million
Reduce all of the lower PIE rates by five percentage points.	+5%	0%	0%	$35 million
TEE for KiwiSaver (strict restrictions on maximum contributions)	+17%	+28%	+28%	$210 million
EET for KiwiSaver (strict restrictions on maximum contributions)	+17%	+28%	+28%	$2,500 million per year in the early years

These estimates are preliminary and presented for indicative purposes only.

Note: These estimates do not account for any behavioural changes arising from the options.

43. Yet the Group is mindful of the fiscal and distributional impacts of poorly-designed concessions for retirement saving. This has led the Group to focus on options that are targeted towards low- and middle-income earners – which, in turn, will disproportionately benefit women (who are more likely than men to be on lower incomes, due to part-time work or time out of the paid workforce for caring responsibilities).

44. The Group sees little value in providing incentives to high income-earners, who are likely to be saving adequately in any case. The Group has also calibrated its recommendations to ensure that any changes are in areas that are more likely to have a net positive impact on national saving.

45. In light of these considerations, the Group recommends a package of modest incentives for retirement saving that is targeted towards low- and middle-income people. Because women on average have lower income than men, this should help to reduce gender gaps in saving. This package comprises:

    - The removal of ESCT for employees earning up to $48,000 *per annum*.
    - A five percentage point reduction for each of the lower PIE rates, applying to savings in KiwiSaver accounts. (The Government could also take the opportunity to simplify the PIE rate schedule, which is somewhat complex.)

46. In making these recommendations, the Group recognises that the tax system is limited in the extent to which it can encourage additional retirement saving by low- and middle-income earners. This is because low- and middle-income earners face income constraints in their ability to take advantage of tax concessions for saving. Further measures to boost retirement savings among these groups (such as direct Government contributions) will rely on spending decisions that are beyond the scope of the Group's Terms of Reference.

47. The Group also notes that it has considered the tax system in light of current retirement policy settings. The Group has not assessed the impact of alternative approaches, such as the introduction of a compulsory saving scheme (which could involve significant tax reform, and will require additional measures to support the transition and ease the burden of contributions on low-income earners). The Government will need to continue monitoring the role of the tax system as retirement policy settings evolve.

Issues with taxing gains on New Zealand and Australian shares

48. Extending the taxation of capital income by taxing capital gains would have implications for KiwiSaver and other savings vehicles, such as PIEs. This means gains from holding shares in New Zealand and Australian companies would be taxed. (The possible mechanics for doing this are set out in more detail in Appendix B).

49. This would impose tax of approximately $15 million per annum across KiwiSaver members with annual income of less than $48,000, and approximately $45 million per annum across higher income KiwiSaver members.[23]

50. The proposed changes the Group is recommending would reduce tax by about $215 million per year for members earning less than $48,000 per year, which would more than compensate this group for the increased tax on domestic shares.

51. If there is a concern that higher income members should also have some offset for the additional tax on investment in domestic shares, consideration could be given to increasing the member tax credit from $0.50 per dollar to $0.60 per dollar, which would generate a benefit of about $190 million per year spread across all members (although lower income members would have a larger proportionate benefit).

52. This would maintain the focus of KiwiSaver incentives on lower-income savers, retain the investment neutrality benefits of extending the taxation of capital income, and avoid risks that tax reductions linked to the nature of the investment itself could turn KiwiSaver into a vehicle for high income savers to generate large tax reductions for savings while contributing little to national savings levels.

53. The Group will give further consideration to the taxation of savings in the Final Report, in light of its broader conclusions on the tax system.

Summary

The Group recommends that the Government:

7.1 Remove ESCT on the employer's matching contribution of 3% of salary to KiwiSaver for members earning up to $48,000 per year.

7.2 Reduce the lower PIE rates for KiwiSaver funds by five percentage points each.

7.3 Consider ways to simplify the determination of the PIE rates (which would apply to KiwiSaver).

The Group will give further consideration to the taxation of savings in the Final Report, in light of its broader conclusions on the tax system.

23 This is based on the level of domestic equities owned by KiwiSaver funds as of March 2018, and the split of income earned by lower-income and higher-income members in 2016 (based on their reported PIE rate). Domestic shares are assumed to increase in value by 3% per year and share amounts grow by 20% per year. Australian shares are not included in the costing due to data limitations, but they are not expected to be large compared to ownership of domestic shares due to the benefit of imputation. This does not take into account a change in investment levels or patterns made by KiwiSaver funds as a result of tax changes. These estimates are preliminary and presented for indicative purposes only.

8

Housing affordability

1. Housing affordability is one of the key issues for consideration by the Group. The Terms of Reference direct the Group to have special regard to housing affordability, as well as to consider whether housing tax measures would improve the tax system.

2. The Group has also received a large number of submissions about the challenge of housing affordability. New Zealanders are concerned about the high cost of housing – for renters and homebuyers – and its impact on wealth inequality and social cohesion.

3. Yet it is also evident that New Zealanders disagree about the causes of the housing affordability challenge. Some New Zealanders believe the tax system is the cause of high house prices; others think it has little impact at all.

4. There are many influences on the housing market, of which tax is only one. This chapter begins by explaining the multiple causes of housing affordability, before exploring how the tax system deals with, and impacts on, the housing market.

The causes of unaffordable housing

5. The cause of unaffordable housing is, in one sense, straightforward. New Zealand is simply unable to build enough houses to satisfy demand at current rates of population growth – particularly in Auckland, where growth is the highest in absolute terms.

6. Estimates of the size of the housing shortfall vary, depending on assumptions about household composition and lag times between building consents and building completions. Nevertheless, the Ministry of Business, Innovation and Employment (MBIE) estimates that the accumulated housing shortfall in Auckland had reached approximately 45,000 dwellings by 2017 (MBIE 2017).

7. This shortfall is the result of a number of interlinked problems in the supply of housing:

   - A combination of land use constraints and infrastructure constraints has limited the supply of land for housing, both within and beyond existing urban areas.
   - Building costs are high in New Zealand. Some of these costs reflect New Zealand's particular circumstances, such as its small market size, and the need to manage natural hazard risks through building standards. Yet productivity growth in the building and construction sector has been low, and the sector faces significant productivity constraints.
   - Many developers are currently finding it difficult to access finance, particularly in Auckland.

8. At the same time, there is high demand for housing – reflecting high rates of population growth in recent years. High demand is not, by itself, a problem. The challenge relates rather to the interaction between supply and demand. If the supply of housing were more responsive (or, in other words, the elasticity of supply were higher), the additional demand could be met with less impact on house prices or rents.

The tax treatment of housing

9. The tax system is another influence on demand for housing. There are currently three main taxes that affect housing: income tax; GST; and local government rates. This section explains how each of these taxes treats housing.[24]

Income tax

10. The income tax system does not formally favour investment in housing. However, the way in which the general principles of the tax system interact with housing can give it a relatively attractive tax treatment in practice.

11. There are two key principles with relevance to housing:

    - ‘Imputed income’ is not taxed. (Imputed income is a term that economists use to describe the benefit a taxpayer derives from using their own capital or labour. Thus, the imputed income from housing is the benefit a homeowner derives from living in their own home rent-free.)

    - Capital gains are not generally taxed, unless they arise in the context of ‘trading’ or a ‘trade-like’ activity, or other provisions, such as the “bright-line” rule.

12. The impact of these principles can be traced across the housing market.

Developers, ‘dealers,’ and other land-related businesses

13. Income from land sales is taxed in the hands of builders, developers, ‘land dealers,’ and people in the business of dividing land. Sales within ten years of purchase or building are taxed, regardless as to whether the land was purchased for the business.

14. There are, however, two exceptions to this approach – regarding the person’s own home, and the premises of the business. Imputed labour income is also not taxed in the case of people who develop and build their own home.

Landholders

15. Gains on the sale of residential land are taxable if the land was bought with the firm intention of resale, even if resale was not the only or dominant intention of purchase. However, this is difficult to enforce.

16. The bright-line test aids with the enforcement of the ‘intention’ rule. The test serves as a proxy for intention of sale – which can otherwise be difficult to enforce – by taxing the sale of any residential property within five years of purchase, subject to some exceptions.

17. Land affected by changes to zoning, consents, or other specified changes may be taxed on sale, if the sale is within 10 years of acquisition. If at least 20% of the gain on disposal can be attributed to the change, the whole gain is taxable. However, the taxable amount is effectively reduced by a deduction equal to 10% of the gain multiplied by each year the taxpayer has owned the land.

18. Land disposals may be taxed if an undertaking or scheme involving more than minor development or division was commenced within 10 years of the land being acquired. Land disposals may also be taxed if there has been a scheme of division or development that involves significant expenditure on specified works, subject to a number of exclusions.

Owner-occupiers

19. Owner-occupiers do not pay tax on the imputed income generated by their homes. The expenses associated with home ownership, such as maintenance and mortgage expenses, are not deductible.

20. Capital gains on owner-occupied homes are not generally taxed. There are some exceptions: the ‘main home’ exclusion from the bright-line test can only be used twice in a two-year period; and owner-occupiers with a regular pattern of buying and selling residential land cannot use the ‘main home’ exclusion for the land sale rules, including the bright-line rule.

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24 In order to provide a complete picture, it includes a discussion of the treatment of owner-occupied homes. However, the Terms of Reference rule out consideration of any reforms that would apply to the family home or the land under it.

Landlords and tenants

21. The rents paid to landlords represent taxable income, and so the expenses associated with the ownership of a residential property investment (including interest) are generally deductible. Allowances for the depreciation of rental housing were eliminated in 2010.

22. Under present rules, losses from residential property investments can be aggregated with income from other sources. (This treatment is not unique to housing: the tax system generally aggregates all the income and deductions of a taxpayer, and applies tax on the net amount.) The Government intends to ring-fence losses on residential property investments, so investors will not be able to offset tax losses from those properties against other income.

23. Capital gains on residential property investments are taxable if the owner acquired the property with the intention of selling it. The bright-line test aids with the enforcement of this rule. However, since most property investors cannot be shown to have acquired property with the intention of selling it, capital gains from residential property investments are not generally taxed in practice. Capital losses are generally not deductible unless the property was bought with the intention of resale.

GST

24. Some supplies of housing are subject to GST, but other supplies are not. The way in which GST is applied means that GST can have an impact on housing even if it is not visible to all participants in the housing market.

Housing developers and sales of new homes

25. Developers are liable for GST when they sell a new residential property, and can claim credits for the GST content of the inputs they use. GST therefore forms part of the price of new homes, just like any other good or service.

26. The GST on the purchase price of a new home can be seen as an up-front payment of the tax on the accommodation services provided by the home over its economic life. Each successive owner then effectively bears part of the GST during their tenure as owner. Expenses related to home ownership, such as maintenance, are also subject to GST for these successive owners.[25]

27. Any subsequent sales of housing by owners who are not housing developers (such as owner-occupiers or residential landlords) are generally not subject to GST.

Landlords and tenants

28. Rent payments by tenants to landlords for housing are exempt from GST. However, GST applies to most of the inputs necessary to provide rental accommodation. This includes the initial cost of GST on the sale of a house by a developer, subsequent improvements by builders, and the costs of some repairs and maintenance. This means that although rental payments are exempt from GST, they do not *escape* GST. Instead it is the personal labour that is provided by a landlord which is the primary aspect of accommodation services that is not subject to GST.

Local government rates

29. Private residential properties are subject to regional and local government rates. Local authorities determine rates annually, mostly on the basis of the assessed value of the property. Rates vary greatly across local authorities.

30. The Productivity Commission has assessed the average impact of rates relative to other forms of taxation. In 2012, rates averaged about 0.6% of the total capital value of residential property. The Productivity Commission calculated that a rate set at 0.6% of the capital value of a property would be equivalent to a tax of between 12% and 20% on the income generated by that property, depending on several key assumptions about the level of income, and whether that income is being measured in nominal or real terms (NZPC 2012). Inland Revenue estimates indicate that rates currently represent an average of approximately 0.3% of market value.

31. Rates apply to all land uses, not just owner-occupied property, so owner-occupied property still has a significant tax advantage relative to other land uses.

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25 When these services are provided by GST registered sellers.

The tax system and the housing market

Savings and investment across the economy

32. The tax system has a range of impacts on the economy. These impacts do not always work in the same direction. An assessment of the cumulative impact of the tax system therefore relies on implicit assumptions about the relative strength of these various impacts.

33. In general, the non-taxation of some streams of housing income is likely to result in higher investment in housing, and less investment in assets that generate taxable returns, than would otherwise be the case. In a context where the supply of housing is constrained, additional residential investment will have a greater impact on the price of *existing* homes than on the construction of *new* homes.

34. This raises an important distinction regarding the balance between the productive and the speculative economy. There are valid concerns about speculative activity in the housing market. Yet there is also a need for productive investment to increase the supply of housing and alleviate the housing shortfall. This speaks to the importance of broader reforms to the housing system – beyond tax – that reduce constraints on the construction of new homes.

The impact of individual aspects of the tax system

Portfolio effects

35. The composition of household portfolios is affected by an incentive to 'save' through mortgage repayments on owner-occupied homes. Homeowners have an incentive to pay off their mortgages ahead of other forms of saving because each dollar repaid on the mortgage is 'saved' at the pre-tax interest rate. Saving through mortgage repayments on owner-occupied homes is therefore more lightly taxed than other types of saving, creating a bias in household portfolios towards the repayment of mortgages.

Non-taxation of imputed income

36. The non-taxation of imputed income encourages more investment in owner-occupied housing by those who can wholly fund the purchase with their own wealth. However, an owner-occupied home that is partly or entirely debt-financed, does not provide the same level of tax benefit as an owner-occupied home that is fully financed by equity. This is because mortgage interest is not deductible.

The inconsistent taxation of capital gains

37. The inconsistent taxation of capital gains biases savings and investment decisions towards assets that are expected to generate untaxed capital gains, rather than assets that generate more regular taxable income streams, such as term deposits. This results in more investment in housing than would otherwise be the case.

38. The non-taxation of capital gains could be resulting in a reduction of rents – benefiting people on lower incomes who are more likely to rent – if greater investment in housing resulted in a greater supply of rental accommodation. Whether this holds in current market conditions in New Zealand is uncertain, so assumptions about the elasticity of supply are critical to an assessment of the distributional impacts of tax changes in the housing market.

39. One rule that may be directly affecting the supply of land is the 'ten year rule', which creates an incentive for landholders on city fringes to withhold land from development until ten years have passed from a change in land use regulation.

GST

40. The tax bias towards owner-occupation mostly arises as a result of our income tax settings. Consequently, the introduction of GST, and subsequent increases to the rate of GST, have reduced the bias in favour of equity-financed, owner-occupied housing to the extent that they have enabled complementary reductions in rates of income tax.

Local government rates

41. Local authorities have the ability to choose the basis on which they levy general rates. There are three methodologies for levying general rates: unimproved land value; capital value; or annual value (a measure of what a property would fetch if rented on the open market). Most councils use capital value for their rating systems.

42. The choice of rating system will have some impact on housing supply. Capital value rating is a tax on improving land. It discourages development and lowers the rates liability of those that hold vacant land, relative to using unimproved land value, which encourages (or at least does not discourage) the development of bare land.

The overall impact of the tax system

43. It is difficult to quantify the impact of the New Zealand tax system on house prices and rents. The housing market is subject to many different influences. Disentangling these influences is no easy task, so there is little definitive empirical evidence regarding the tax impact on house prices and rents in New Zealand.

44. As one example, Coleman (2017) argues there is a strong theoretical case that changes to the taxation of retirement savings in the late 1980s increased house prices. But Coleman also finds that the empirical evidence for this result is inconclusive, partly because so many other macroeconomic changes occurred at the same time that it is difficult to link changes in housing market indicators to the tax changes themselves.

45. Most observers do not identify tax policy as the primary cause of high house prices. The OECD, for example, conducted a detailed survey of New Zealand's housing sector in 2011, and concluded that tax settings 'exaggerated' rather than caused the rise in prices in the mid-2000s (OECD 2011).

46. It is likely that tax policy has exacerbated the house price cycle in New Zealand over the past two decades. But the existence of substantial constraints on the supply of housing means that tax policy is unlikely to be the dominant driver of high house prices.

Assessment

Reforms to increase the supply of housing

47. Although tax reform is unlikely to be the dominant driver of the housing markets, the Group has identified a number of options that could release some additional supply.

Depreciation on multi-unit residential buildings

48. The restoration of depreciation on multi-unit residential buildings would increase the supply of housing and support greater intensification in urban areas. The treatment of depreciation is discussed further in Chapter 14 on *The taxation of business*.

Vacant land and empty home taxes

49. The introduction of a tax on vacant residential land, or on empty homes in residential areas, would intensify the use of existing urban areas. There are already examples from Australia that could inform the development of similar taxes in New Zealand:

    - Australia introduced a measure in its most recent budget that denies deductions associated with holding vacant land. While this measure is not a tax on vacant land, it does provide a tax incentive to utilise vacant land for either residential or commercial purposes.
    - Australia also introduced a measure in 2017 that imposes a flat fee of $A5,000 on foreign-owned properties that are not occupied or are not genuinely available for rent for more than 6 months.

50. The main risk with these taxes is that they encourage the token (rather than substantive) use of land or houses. Nevertheless, the Group believes there is merit in the consideration of taxes on vacant land and empty homes (over and above existing local government rates) to encourage housing development. Any new housing development spurred by these taxes would need to occur on a planned and environmentally sustainable basis.

The removal of the 'ten year rule'

51. The removal of the 'ten year rule' related to changes to zoning, consents, or other specified changes would reduce the incentive to engage in land-banking behaviour on city fringes. The effects would probably be minor, but the rule will need to be reconsidered in any case if capital income taxation is extended further.

Local government rating systems

52. Some submitters have suggested that the Group consider the balance between central and local government taxation. The Group has decided not to explore this issue, in light of the Government's decision to commission a Productivity Commission Inquiry into *Local Government Funding and Financing*. Nevertheless, the Group believes strongly that central government should steer the overall framework of central and local government taxation.

53. The Group does note, however, that a shift from capital to unimproved land valuation will increase the incentive for owner-occupiers to increase the capital investment in their properties. This will increase the supply of housing to some degree. In making this observation, the Group acknowledges that a broad range of considerations – beyond housing affordability – will need to affect the choice of rating methodology.[26]

The housing market impacts of capital income taxation

54. Chapter 6 introduced a number of options for extending the taxation of capital income. These measures will affect the housing market, and may affect house prices and rents in different ways.

Distributional considerations

55. Patterns of housing tenure and housing stress differ greatly by income, ethnicity, and region. The following statistics give a sense of the range of housing outcomes across different groups of New Zealanders:

    - **Income.** In 2017, 54% of households in the lowest income decile lived in a home that was owned by them or their family trust, compared to 78% of households in the highest income decile.
    - **Ethnicity.** In 2013, the percentage of people in households that owned their own home ranged from 33% for Pacific Peoples and 43% for Māori to 70% for Europeans. In December 2017, 44% of the people on the Social Housing Register, and 57% of the people who received emergency housing grants, were Māori.
    - **Region.** In 2013, the percentage of dwellings rented ranged from 27% in Tasman to 41% in Auckland and 43% in Gisborne.

    Johnson et al. (2018), MSD (2017), (SNZ 2017).

56. A social capital lens requires a consideration of the distributional impact of policy reform. Rents can serve as a proxy for assessing these distributional impacts, since measures that affect rents will have a disproportionate impact (whether positive or negative) on groups and individuals who are already relatively disadvantaged.

Potential impacts on house prices and rents

57. The extension of capital income taxation (for example, through the introduction of a tax on capital gains from residential property investments) could be expected to have a number of impacts on housing markets, including some upward pressure on the ratio of rents to prices.

26 The Group also acknowledges that the valuation system and practices are outside the scope of the Productivity Commission's Inquiry into *Local Government Funding and Financing*.

58. The Group has explored the impact of similar tax changes on housing markets in other countries (including Canada, Australia, and South Africa). The Group has not observed significant increases (and, to the contrary, rent to price ratios have fallen rather than increased in these countries). But it is difficult to know what other influences were affecting housing markets in those countries at the time of the changes.

59. The Group has also reviewed the results of two theoretical models. These models have both estimated an increase in the ratio of rents to prices and rents. However, they have inconsistent estimates for the effects on house prices.

60. There are some important caveats to the modelling. Models used in New Zealand either ignored the impact of risk and uncertainty or provided a very simplified treatment. The models reviewed by the Group assume that current tax parameters, interest rates, inflation, and future returns on housing are all known, and are perfectly certain to continue into the indefinite future.

61. International studies warn, however, that these types of 'certainty models' can overstate the effects of tax changes on housing decisions. These studies also observe that taxing gains and allowing losses on housing can reduce risks to investors, and have some offsetting benefits, which are not captured in certainty models.[27]

62. If housing investors think there is a chance that their investment will fall in value, an extension of capital income taxation with symmetric treatment of gains and losses will mitigate the 'cost' of the tax, because the design of the tax will provide protection on the downside, as well as taxation on the upside.

Interactions with the Accommodation Supplement

63. Under current rules, some tenants receiving the Accommodation Supplement will receive an increase in their entitlement if rents increase.

64. Some recipients, however, will not receive any increase however. Around 23% of those receiving the Accommodation Supplement are already receiving the maximum payment.[28] This group of people are unlikely see an increase in their Accommodation Supplement entitlement if their rents increased.[29]

Summary

8.1 The Group's work on housing affordability is closely linked with its work on the taxation of capital income. The Group will have particular regard to housing market impacts as it finalises its recommendations regarding capital income.

27 See, for example, Rosen, Rosen and Holtz-Eakin (1984) and Berkovec and Fullerton (1992).

28 Data supplied by MSD for June 2018.

29 A benefit recipient may be eligible for an increase in their income support from Temporary Additional Support (TAS).

9

Environmental and ecological outcomes

1. Natural capital is one of the four capitals of the Living Standards Framework, and one focus for the Group has been to explore how Te Ao Māori perspectives can inform our understanding and application of the Living Standards Framework with regard to natural capital.

2. Waiora – which is commonly used in Te Ao Māori to express wellbeing – centres our conception of wellbeing in wai (water) as the source of all life. As human beings, we are largely comprised of water, and we draw our sustenance from the natural environment. Our wellbeing is inextricably linked to the wellbeing of our natural capital. Our success in managing ourselves in relation to these natural systems and resources will determine the sustainability and wellbeing of our people over time.

3. Due to the symbiotic relationship of all things in the natural world, there is mutual benefit in responsible management of ourselves in relation to natural resources. From a tikanga perspective, kaitiakitanga (stewardship) encapsulates our obligations to undertake responsible resource management of our natural capital, as a basis for the sustainable development of our human, social, and physical and financial capitals. Extending the principles of kaitiaki to the way we manage these four capitals collectively can support our approach to achieving wellbeing for our environment and our people.

4. It is also important to acknowledge that the natural environment has intrinsic value that goes beyond utility, because our sense of who we are as people is deeply embedded in our connection to it. Through manaakitanga (care and respect), we are incentivised to practice kaitiakitanga, and our whanaungatanga (relationships to each other) are enhanced.

5. These values are not exclusive to Te Ao Māori. It is evident from public submissions that many New Zealanders are deeply concerned about the state of the environment. Their concerns cover effects at the local, national, and global levels including pollution in our waterways, declining biodiversity, threats to our coastal zones, and the impacts of climate change.

6. The Group has been tasked to respond to these concerns by examining the role the tax system can play in delivering positive environmental and ecological outcomes, especially over the longer term.

System goals and principles

7. The environmental challenges ahead of us – including de-carbonising the economy, improving the quality of our freshwater, and enhancing coastal habitats – require profound change to the structure of economic activity. It is therefore necessary for policymakers to think in terms of *systems change* – and to develop a set of goals and principles that can guide a transition, over many decades, to more sustainable patterns of economic activity.

8. Under traditional economic approaches, environmental challenges are costly and a transition will be expensive, unless benefits and pathways to possible solutions are mapped.

9. Our framework, grounded in tikanga Māori, can support and enrich the transition towards greater systems thinking, as mātauranga Māori already contains knowledge systems and frameworks that reflect a holistic and interconnected view of the natural world and its resources.

10. The circular economy envisages a system in which we keep resources in use for as long as possible, extract the maximum value from those resources while in use, and then recover and regenerate materials at the end of their service life.[30] Tikanga, such as kaitiaki and manaaki, and mātauranga Māori more broadly, can help facilitate transitions that move towards more sustainable management practices like the circular economy. Observations of sustainable resource management have formed the basis of these knowledge systems which are preserved in mātauranga Māori and tikanga values. Synergising the knowledge systems of Aotearoa/ New Zealand will improve on what we currently have, and accelerate our potential to achieve our collective resource management, sustainability, and development goals.

11. These connections between healthy ecosystems and human well-being are also reflected in the Sustainable Development Goals. The United Nation's Sustainable Development Goals are signed by all 193 UN member states, including New Zealand, and provide a set of timebound goals across all domains of wellbeing. In the environmental sphere, the goals set targets for clean water (SDG6), climate action (SDG13), life below water (SDG14), and life on land (SDG15). The Sustainable Development Goals provide one blueprint for defining and measuring a just transition over time.

12. The Group notes that many of these goals and concepts are already beginning to inform the public debate on the future of the economy, including through the Living Standards Framework. The Group encourages further efforts to develop a shared vision about the goals and pathways towards an 'Aotearoa Economy' that can be sustained within a safe ecological operating space.

The role of taxation

13. As outlined in Chapter 1, taxation is not simply a means of raising revenue. Taxation can also be used as an instrument to achieve specific policy goals by influencing behaviour.

14. As an initial step, the Group has considered taxation in the context of negative environmental externalities. In economics, an externality is a cost or benefit that falls upon an unrelated third party. One example of a negative environmental externality is air pollution from an industrial plant that reduces air quality in a neighbouring district: the residents in that district may have no connection to the industrial plant, but nevertheless suffer the effects of the downwind air pollution.

15. On the other hand, behaviour changes can also produce positive externalities. For example, changes in farm practice may lead to downstream improvements in water quality that increase the production of ecosystem services.

16. The Group has also taken a broad view of potential tax instruments. The Group's working definition of taxation in this context is *economic instruments that can be potentially revenue-raising for central or local government and improve environmental outcomes.* Environmental outcomes could be improved by encouraging behaviour change, and/or by funding environmental improvements, mitigation works, or assisting people through change. The definition encompasses nationally-uniform taxes or levies, locally-variable taxes or levies, and tradeable emissions permits for national and local markets where the permits are sold by the Government.

17. Taxation is not necessarily the best tool to change behaviour. Sometimes, it may be more effective or efficient for the Government to consider regulation or spending; in other cases, taxation may be complementary. As has been stressed by public submitters, tax should not be considered in isolation when dealing with the environment; instead, the merits of tax as a policy instrument should be assessed together with the merits of other tools and approaches.

30 Other alternative economic approaches include ecological economics, transitioning economics, regenerative economics, sharing economics, and doughnut economics.

Environmental taxes in New Zealand

18. Statistics New Zealand estimates that in 2016, the Government raised $4.9 billion in environmental taxes, as defined by the System of Environment Economic Accounting (SEAA). This was equivalent to 6.2% of tax revenue, up from 4.8% in 1999 (Stats NZ 2018).

19. Most of New Zealand's environmental tax revenue is from taxes that are levied for non-environmental purposes. 47% of environmental tax revenues are classified as transport taxes, such as road user charges and vehicle registration fees (Stats NZ 2018). A further 51% is classified as energy taxes, which is primarily made up of transport fuel taxes, such as petrol excise duty. These transport-related taxes are largely hypothecated back to transport (especially roads) through the National Land Transport Fund.

20. The balance of environmental taxes is made up of pollution taxes (1%) such as the Waste Disposal Levy, and resource taxes (1%) such as energy resource levies. There are plans for the Government to begin auctioning units under the Emissions Trading Scheme which could also constitute environmental tax revenue.

21. The OECD finds New Zealand to be a relatively low user of environmental taxes. New Zealand is ranked 30th out of 33 OECD countries for environmental tax revenue as a share of total tax revenue in 2013 (OECD, 2018).

When to apply environmental taxes

22. Over the past months, the Group has developed a framework for deciding when to apply taxes to address negative environmental externalities. The draft framework, which is presented in box 9.1, sets out the circumstances in which taxation is likely to be an effective tool, and the characteristics of a well-designed externality tax.

23. The Group has also considered taxation of natural resource use (or resource rents). A draft set of principles, based on those previously used for assessing New Zealand's petroleum and minerals royalty regimes (MBIE 2012) are presented in box 9.2.

Opportunities for environmental taxation

24. The Group has considered potential changes to the tax system to support better environmental and ecological outcomes over the short, medium and longer terms, using these frameworks.

25. The Group wishes to highlight five specific areas for further attention in the short-to-medium term: greenhouse gas emissions; water pollution; water abstraction; solid waste; and road transport.

26. The following discussion focuses on criteria in the negative externality framework which are only partially met, and on design principles of particular relevance to each resource.

Greenhouse gas emissions

Evaluation against the framework

27. Greenhouse gases generally meet the criteria of our framework, suggesting they are well suited to the use of tax instruments (where tax instruments include auctioned tradeable emission permits). Of particular note is the wide range of abatement opportunities. This means abatement of emissions is likely to be achieved at a lower cost by using taxation than by mandating particular actions through regulation. There is also evidence that putting a price on greenhouse gas externalities drives innovation in abatement (Dechezlepretre, Martin & Bassi 2016). Greenhouse gases could be a significant source of revenue over the medium term.

28. Our framework also highlights potential challenges with applying tax instruments to greenhouse gases which are briefly explored below – namely concerns with measurement, international linkages, and pricing.

29. New Zealand already has an environmental tax tool for pricing greenhouse gases in the form of the New Zealand Emissions Trading Scheme (ETS).

Box 9.1: Draft framework for taxing negative environmental externalities

Taxation can be used as a tool to enhance natural capital when unpriced externalities lead to the over-exploitation of resource stocks and degrade the integrity of ecosystems. The suitability of taxation as a policy instrument – relative to other instruments such as regulation and spending – can be assessed through the following principles:

- *Measurability:* The damaging activity, or a reasonable proxy of it, can be measured.
- *Behavioural responsiveness:* The level of damaging activity is relatively responsive to feasible price signals (i.e. it is relatively price elastic). If the damaging activity is relatively price inelastic, a tax might still be desirable for the objective of raising revenue.
- *Risk tolerance:* There is sufficient time for a tax instrument to be developed and refined.
- *Sufficient scale:* The environmental problem is sufficiently large-scale and persistent to justify administration and compliance costs in comparison to regulation.

The benefits of using taxation as an instrument may be greater when the following criteria are met:

- *Diversity of responses:* There is a range of abatement responses with differing costs, including investment in innovation, such that regulating a particular response could impose high costs.
- *Revenue raising potential:* Large revenues could be raised from the tax, allowing for the reduction of more distortionary taxes and/or spending on other government priorities.

Principles for designing externality taxes

The general principles of tax policy design can also apply to environmental taxes. Building off these, there are five design principles which warrant particular attention:

- *Māori rights and interests* must be acknowledged and addressed.
- *Distributional impacts* should be assessed and mitigated.
- The price of the tax should reflect the full cost of externalities.[1]
- The price should preferably vary locally where there is local variation in impacts.
- *International linkages* should be considered.

1 External costs can be difficult to estimate. A tax that is 50 percent above or below the true cost will still likely perform well in terms of welfare gains (Parry, Norregaard, & Heine, 2012). In situations where certain externalities cannot be costed, the price of the tax may need to be set higher than the costed externalities to allow for un-costed externalities.

Box 9.2: Draft principles for taxing natural resource use

Taxes on natural resource use can be used to compensate resource owners and as a means to efficiently raise revenue. The following principles have previously been used for evaluating New Zealand's royalty regimes:

- *Ensuring a "fair" return to the resource owner.* The tax should seek to recover the resource rent, while ensuring adequate incentives for investors to develop resources.
- *Economic efficiency:* Deadweight losses should be minimised. In theory, a tax levied on pure rent will be non-distorting. In practice, it is difficult to tax pure rent and resource tax instruments will introduce distortions and deadweight losses.
- *Administrative complexity:* Tax instruments should aim to be simple and transparent. There is often a trade-off between the theoretical efficiency of a resource tax, and its administrative complexities and costs.
- *Risk sharing between the Crown and industry:* Risk should be allocated to the party best able to manage or tolerate it. Different tax instruments split risk differently between the Crown and industry, especially commercial risk and price risk.

Measurement

30. Greenhouse gas emissions from agriculture are more difficult to accurately estimate than point source emissions from fossil fuels. This has been an important issue in expanding the ETS to include agriculture. There are different approaches to measuring agricultural emissions:

    - At the more precise end of the spectrum are modelling tools which attempt to account for farm-specific characteristics. These tools can be expensive to administer, but account for some differences in farm management practices. One example of these tools is OVERSEER, which is a nutrient budgeting and management tool. OVERSEER has been criticised with regard to its accuracy as a measuring tool. The Group supports further work on its development and improvement.
    - At the less precise end of the spectrum are approaches such as processor-level charges. These approaches are simpler to administer and encourage some mitigation, but do not reflect differences in farming management practices.

31. There is still much work to do on this issue, but the Group notes that even imprecise approaches could provide a useful price signal that accounts for land use and intensity decisions.

International linkages

32. If New Zealand imposes the full cost of carbon, but other countries do not, there is a risk of 'emissions leakage' – in which production contracts here, and expands in countries with weaker climate action, with no net global reduction in emissions (Levinson & Taylor 2008).

33. At a minimum this points to the importance of supporting globally coordinated action. There are also policy options for mitigating leakage risks. These options include free allocation to impacted industries, targeted revenue recycling, and regulation to level the carbon playing field between domestic producers and importers.

34. There are potential benefits from taking faster action on climate change. It could encourage innovation and reduce the cost to meeting international commitments.

The Emissions Trading Scheme and pricing

35. As noted above, New Zealand already has a tool for pricing carbon in the form of the ETS. A carbon tax is another economic instrument that could be used to price emissions.

36. A major criticism of the ETS is that it has significantly under-priced carbon.[31] The Productivity Commission reports that New Zealand's emissions price (currently at \$NZ21/t-CO_2e) will need to rise to at least \$75/t-CO_2e and possibly over \$200/t-CO_2e over the next few decades to achieve New Zealand's international commitments (New Zealand Productivity Commission, 2018).

37. There is scope to address the weaknesses of the ETS without needing to introduce a carbon tax. Some reforms have already taken place – for example, removal of the one-for-two policy.[32] The Group also notes a range of reforms recommended by the Productivity Commission, including an emissions price that covers all land use (including agriculture), introducing mechanisms that provide guidance about the path of future emissions prices, and auctioning emission units (NZUs) to achieve this (NZPC 2018). The ETS could also raise the same amount of revenue as a carbon tax if free allocation were reduced.

38. Retaining the ETS also supports policy stability and durability. It is sensible to take advantage of the existing infrastructure around the ETS. It is also important to give stability about the long-term direction of policy, so that businesses and individuals have the confidence to invest in emissions abatement.

Revenue potential

39. The Government does not currently auction emission units, but could realise significant fiscal benefits by doing so.

40. The fiscal potential of greenhouse gas emissions depends on policy choices about the treatment of biological emissions and limits to free allocation. The Group has modelled different revenue scenarios based on carbon budget forecasts from the Ministry for the Environment.

41. Under current settings, and assuming the NZU price rises to \$50/t-CO2e in 2030, the auction of NZUs is forecast to raise approximately \$130 million *per annum* over the coming decade.

42. If agriculture faces a charge for 5% of its emissions, and free allocation is reduced linearly by 1%-point each year, revenue will roughly double to \$240 million *per annum*, assuming no change in emission volumes.

Table 9.1: Fiscal potential from auctioning emission units

	Share of biological emissions charged for	Change in free allocation, relative to current rates	Average annual forecast revenues, 2021-30
Status quo	0%	0%	\$130 million
Scenario 1	5%	Reduction of 1%-point p.a.	\$240 million
Scenario 2	5% in 2021, increasing 3%-points p.a.	Reduction of 3%-points p.a.	\$530 million

Note: The modelling is based on current MfE carbon budget projections. It assumes no change in emission volumes as a result of changes in free allocation or biological emission charging, and also assumes a linear increase in the emissions price from \$20/t-CO2e in 2021 to \$50/t-CO2e in 2030.

Source: Ministry for the Environment and Tax Working Group Secretariat.

31 Stiglitz-Stern estimate the Paris Agreement objectives require a pricing corridor of \$US40-80/t-CO_2e in 2020 and \$US50-100/t-CO_2e in 2030 (Stern & Stiglitz, 2017). This is roughly equivalent to \$NZ58-116/t-CO_2e in 2020 and \$NZ73-145/t-CO_2e in 2030. Biological emissions – almost half of New Zealand's total emissions – are also excluded from the ETS.

32 The one-for-two transitional measure allows non-forestry businesses to pay one emissions unit for every two tonnes of CO_2e emissions.

43. If free allocation reductions increase to 3%-points each year (the upper end of broad-based reduction rates being considered by other countries), and this same reduction rate is also applied to agriculture, revenue will double again to $530 million *per annum*.

44. The total revenue that could be raised by removing all free allocation is estimated to be $2.1 billion *per annum*, assuming no change in emission volumes. This is equivalent to replacing the ETS with a comprehensive carbon tax, assuming prices are the same.

45. Revenue will be sensitive to the emissions price. If the price rises to $80/t-CO2e in 2030 (the highest rate in scenarios used by the Productivity Commission), revenue will increase by approximately 40% above the estimates in the table. At $30/t-CO2e (the lowest rate in Productivity Commission scenarios), revenue will decrease by approximately 27%.

46. In the longer term, greenhouse gas emissions may not be a reliable tax base if New Zealand substantially reduces its net emissions. In the short-to-medium term, however, even modest changes to the ETS settings could raise reasonable amounts of revenue.

Assessment

47. Greenhouse gases are well suited to the use of tax instruments. However, there are significant shortcomings in the current pricing and coverage of emissions in New Zealand.

48. The Group believes a reformed ETS should remain the centrepiece of New Zealand's emissions reduction efforts, but it should also be made more 'tax-like' – specifically, by providing greater guidance on price, and becoming revenue raising by auctioning of NZUs, as recommended in the Productivity Commission's report. The Group is not well-placed to take a view on specific settings, such as the appropriate settings of a price band to drive the desired behaviour change. The work of the Interim Climate Change Committee and future Climate Commission will be important for ensuring the ETS establishes credible and enduring price signals that incentivises the de-carbonisation of the New Zealand economy.

49. The Group recommends periodic review of the ETS to ensure it is fit for purpose.

Water pollution

Evaluation against the framework

50. Pollution of fresh waterways is a significant environmental problem in New Zealand. There are a range of water pollutants impacting water quality including nitrogen, phosphorous, sediment, and pathogens such as *E. coli*. Water pollutants come from both rural and urban sources (MfE 2017).

51. Applying our framework to water pollution, a number of criteria are only partially met. Output measurement of diffuse pollutants is challenging and modelling of some water pollutants is more difficult than others. Opportunities for abatement will vary by catchment, as will the environmental benefits. Risk tolerance may have been exhausted in some catchments, and banning of discharges might be required to restore them to a healthy state. In designing potential tax instruments, consideration of Māori rights and interests will be critical, as will pricing and equity issues. Measurement and pricing issues are further explored below.

Measurement

52. There are significant measurement challenges for water pollutants: estimates of emissions can be imprecise, and the coverage of pollutants is incomplete. For example, our capacity to model sediment, pathogens and phosphorous run-off is significantly less advanced than nitrogen using tools like OVERSEER.

53. The better the measurement, the clearer the price signal is to reduce harmful emissions. Nonetheless, tax instruments based on relatively coarse estimates (e.g. input-based approaches such as fertilizer use) may be better than the status quo for some pollutants, such as nitrogen. They can provide a price signal that is sensitive to land use and intensity decisions, and incentives to abate below consent levels.

54. The Group is aware that the Parliamentary Commissioner for the Environment is currently reviewing OVERSEER, although not specifically for its use as a tax instrument.

Localisation of pricing

55. Water pollution costs vary significantly by location. The marginal cost of emissions differs significantly across catchments, based on a range of geophysical variables and the level of current emissions. Pricing and taxation should also allow for local variation.

56. Locally-variable pricing tools could take various forms. For example, catchment-level nitrogen discharge trading schemes have already been used in the Lake Taupo catchment, and are planned for the Rotorua Lakes; an alternative might be a national tax levied on estimated emissions with catchment-level variation in rates.

57. Locally-variable pricing tools could involve significant administrative and compliance complexity. An alternative approach is nationally uniform charging – for example, a fertilizer tax.

58. Setting the price may require making challenging value judgements about the desired level of water quality. This is a key function of the National Policy Statement on Freshwater Management. Swimmability, drinkability, ecosystem health and aesthetic amenity considerations point to a range of possible standards. There may also be challenges in valuing and accounting for lost fauna, flora and ecosystems.

59. As with other environmental resources, it may not be possible to reflect the full cost of water pollution in the price, but this shouldn't preclude the use of tax instruments in pursuit of positive environmental and ecological outcomes.[33]

Revenue potential

60. The Group has not found comprehensive estimates of the revenue that could be generated from water pollutant taxes in New Zealand. To give a sense of the potential magnitude, the Group estimates that a $2/kg charge on leached nitrates could raise approximately $270 million per annum at current leaching rates and assuming 100% coverage.

Assessment

61. If Māori rights and interests can be addressed, there could be a role for making greater use of tax instruments to address water quality with current tools, especially for nitrogen, and especially for regions struggling with excessive discharges. Even tax instruments using simple estimation approaches are likely to be preferable to having no tax or pricing instruments.

62. Water pollutant tax rates should preferably be sensitive to local catchment conditions (e.g. through local trading markets, or locally differentiated rates). Pricing / charging frameworks and systems should be developed, potentially at a national level for local application, to reflect this.

63. Further development of tools to estimate (and ultimately directly measure) diffuse water pollution should be encouraged to enable more accurate and effective water pollutant tax instruments. Capabilities and capacities should be strengthened for development and application of modelling tools, as well as verification of compliance.

64. Tax instruments are not well suited to addressing all water pollution issues. Regulation, education and support will therefore likely need to continue to play an important role in complementing potential tax instruments.

33 Costing externalities is important for the design of both tax instruments and regulation – both require policy makers to balance costs and benefits.

Water abstraction

Objectives of a water abstraction tax

65. Water abstraction taxes have a broader set of potential objectives than some of the other environmental tax opportunities. They include:

    a) Rationing the total water take (i.e. pricing externalities)

    b) Improving the efficiency of water use within allowable water takes (i.e. ensuring that those who use the water are those that get the most benefit from it)

    c) Taxing natural resource use (i.e. capturing resource rents)

66. The Government has taken a regulatory approach to the first objective – minimum flows and maximum takes are set following processes outlined in the National Policy Statement for Freshwater Management. Water tax instruments can play a complementary role, supporting the second and third objectives.

Evaluation against the framework

67. Fresh water abstraction generally meets the criteria in our framework. Measurement of major water takes is generally feasible, price signals can incentivise significant changes in behaviour, and unlike many other environmental taxes, there is potential for significant long term revenue.

68. There are, however, significant design considerations that would need to be addressed before advancing potential water tax instruments, including addressing Māori rights and interests, pricing localisation concerns, and equity issues.

Māori rights and interests

69. Any potential water taxes will need to take account of Māori rights and interests in water. There are well established concerns about not only questions of ownership, but also of access. Māori have less access to water than other land owners. Analysis from MPI suggests that in drier regions of New Zealand, only 3% of good quality Māori-owned land is irrigated, compared to 27% of all good quality land. There is ongoing work to better address Māori rights and interest in water, including through the Waitangi Tribunal, and discussions between the Crown and iwi/Māori.

Localisation of pricing

70. Water allocation pressures vary significantly by both time of year and catchment.[34] Tax instruments should therefore preferably be sensitive to both time and place to reflect differences in the scarcity and value of water.

71. Better pricing of water has the potential to not only incentivise a broad range of efficiency measures by water users, but also increased investment in water storage and transport infrastructure.

72. There are risks to having tradeable water rights in highly localised water markets – there may be a small number of participants making it difficult to ensure competitive processes. The administrative costs of tradeable water schemes will also need to be considered.

Equity and distributional impacts

73. Equity and efficiency considerations suggest environmental and resource taxes should, by default, have broad coverage. Applying this to water abstraction, this means all exclusionary users of water should be in scope for potential water taxes, including agriculture, hydroelectric generators, and urban users. Special consideration may be warranted for non-consumptive users of water, such as hydroelectric generation. Water may still have value after non-consumptive use, although its ecological and economic value may have been depleted.

74. There are equity challenges in any potential allocation of water rights. Some of the value of existing water consents is likely capitalised in land prices and hydroelectric generator share prices. These equity concerns will need to be balanced against the interests of those who currently do not have (and cannot currently get) water consents, as well as the expectations of

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34 The value of water will also be sensitive to the prices of the products produced using the water e.g. milk and electricity.

a fair return to the public, Crown or Māori. The Group also acknowledges that water bodies may themselves have rights and interests, as recognised in the granting of legal personhood to the Whanganui River.

75. The distributional impacts on households of a water tax will also need to be considered, both from the direct cost of water charges, and the incidence of any water charges imposed on firms (e.g. agriculture and electricity providers). People cannot live without water, and it will be important to ensure that households have affordable access to water. Policies such as free allocation allowances could be considered to mitigate these concerns.

Assessment

76. The Group acknowledges that water abstraction is a particularly challenging policy area in New Zealand, owing to a range of different interest in the resource. Water is an essential resource for life, for recreation and for commerce. Water policy also impacts on Māori rights and interests.

77. If Māori rights and interests can be addressed, water tax instruments (including auctioned tradeable permits) could be useful tools for improving the efficiency of water use. They could also be significant and sustainable source of revenue over the long term.

Solid waste

Evaluation against the framework

78. Solid waste meets the criteria in our framework for the application of an externality tax. Solid waste streams are generally measurable. There is a diverse range of waste reduction opportunities including greater resource recovery and recycling, and investment in product designs and circular systems. Overseas experience has shown landfilling to be responsive to price signals. Waste taxes also have the potential to raise significant revenue in the short-to-medium term.

79. New Zealand already taxes waste through the Waste Disposal Levy. The levy is set at a rate of $10 per tonne, and applies only at landfills that accept household waste. The limited scope means the levy is only applied to 11% of landfills, covering approximately 30% of waste disposed to landfills. The levy currently raises about $30 million per annum (MfE 2017).

Pricing

80. Well-run landfill sites internalise many of the environmental costs in the disposal fees they charge. However, even well-run landfills generate externalities, which may include leachates, air emissions (other than greenhouse gases covered by the ETS), and reduced amenity.

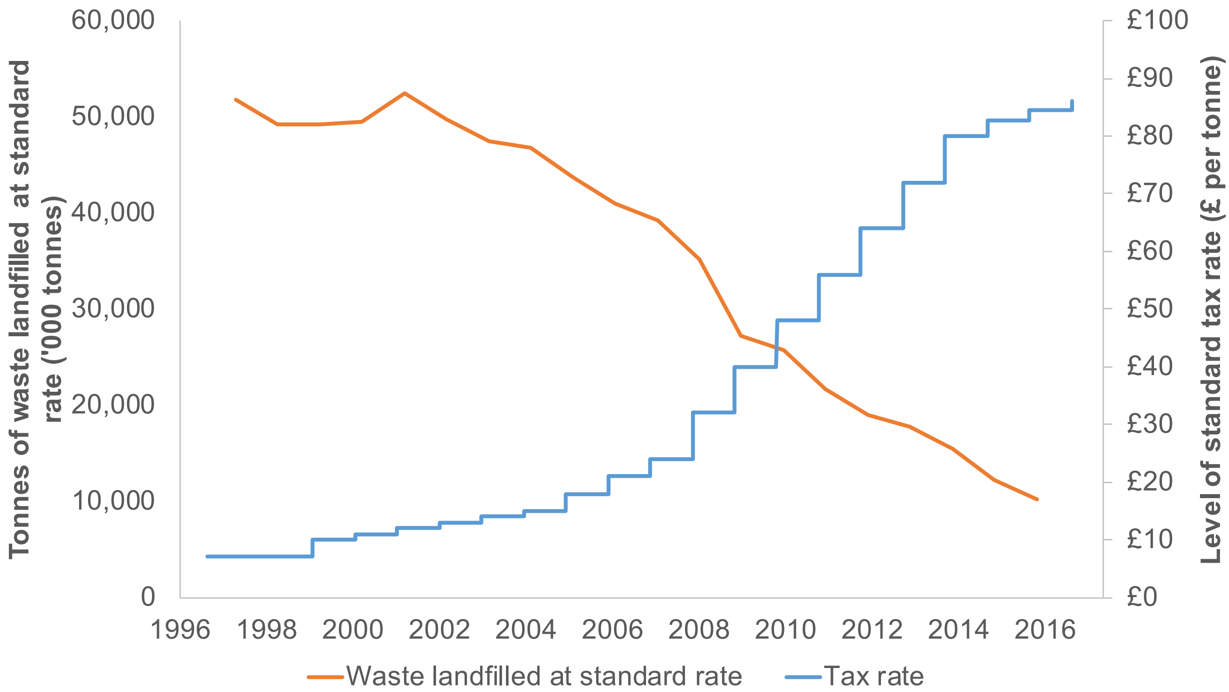
81. It is unclear whether the levy fully prices the externalities associated with waste and landfill disposal. Robust estimates of these externalities are challenging, and depend on the site and waste product. However, a review in 2012 estimated the costs of the environmental externalities – over and above the disposal costs of the landfill – range from $1-$19 per tonne (Covec 2012). These estimates take a relatively narrow view of the externalities from waste, so it may be appropriate to look at a wider set of externalities, which may justify a higher rate. Higher rates might also be needed to achieve behaviour change.

Behavioural responsiveness

82. A significant increase in the levy rate will likely change behaviour. Waste is price elastic, and overseas experience suggests that higher landfill taxes reduce waste production and increase recycling (Covec 2012). In the United Kingdom, for example, higher landfill taxes have driven extraordinary reductions in landfill volumes.

83. Increased efforts will be necessary, however, to mitigate the risk that individuals resort to illegal dumping to avoid the levy. This could include reuse and recycling programmes, stronger illegal dumping penalties, and education programmes.

Figure 9.1 Landfill tax rates and waste volumes in the UK



Source: HMRC, 2017

Fiscal potential

84. The Waste Disposal Levy currently raises approximately $30 million per annum.[35] A recent study by Eunomia, commissioned by the New Zealand Waste Levy Action Group, modelled revenue changes from increases in the levy to up to $140/t for standard waste with a lower rate for inert waste (Eunomia 2017). The modelling exercise found up to $200 million in additional annual revenue from rate increases. The Group has not fully assessed modelling assumptions or approaches used in this analysis.

85. In the long run, the price elasticity of waste means that waste taxes may not be a sustainable tax base.

Assessment

86. The Ministry for the Environment is currently undertaking policy analysis to expand the scope and rate of the Waste Disposal Levy. The Group supports this work programme. There is a case for expanding the coverage of the Waste Disposal Levy beyond the 30% of waste currently covered, potentially with split rates to account for different external costs associated with different types of waste.

87. The Group recommends a reassessment of negative externalities associated with waste and landfill disposal in New Zealand to test for externalities beyond the scope of studies to date, and to ascertain if higher rates are warranted and what rate would be appropriate. If higher rates are introduced, they may benefit from being implemented after the expansion of coverage to prevent leakage to unlevied landfills, and may require accompanying incineration levies if the intention is to drive a reduction in waste generation.

88. The Group also supports revisiting the current approach to hypothecation of the Waste Disposal Levy, especially if there are significant increases in funds raised, to ensure they are being used in the most effective way to move towards a more circular economy.

35 Approximately half of the funds raised goes to local councils and half is hypothecated to waste reduction projects through the Waste Minimisation Fund.

Road transport

Evaluation against the framework

89. Road transport generates a number of different negative externalities. These include road damage, congestion, greenhouse gas emissions, air pollution, noise, surface pollution, and injuries and death. Some of these externalities better meet the criteria for negative externality taxes than others, but there is generally a good fit.

90. There are already a number of tax instruments which address some road transport externalities. For example, the ETS prices greenhouse gas emissions, and petrol and registration levies fund costs relating to injuries and death. Some other externalities have historically been more difficult to price because of measurement and pricing challenges.

Measurement and pricing

91. Congestion is likely to be the largest unpriced externality in road transport. Local air pollution, surface pollution and noise are also unpriced. These externalities are highly specific to time, place, and type of vehicle. This has historically created measurement and pricing challenges.

92. There are now a range of technical solutions to make measuring and charging for these externalities feasible. For example, an enhanced road user charging system that captures information on location, time, type of vehicle and load could allow for more refined pricing of a broad range of externalities.

Equity

93. Several submitters raised equity concerns with transport pricing, especially with regards to the impact of fuel taxes on low income households. It is difficult to generalise about the impact of transport taxes. It will be important to assess the distributional impacts of specific proposals, and equity constraints could mean that pricing is used to signal some types of externalities, rather than accurately price them.

Assessment

94. The Government and Auckland Council are currently working on the Congestion Question project (formerly known as the Auckland Smarter Transport Pricing Project) to investigate whether or not to introduce congestion pricing in Auckland. The Government's Urban Growth Agenda is also scoped to review the future of the transport revenue system. The Group supports these reviews as an opportunity to better align road transport charges with externalities.

Petroleum and minerals

95. New Zealand has royalty regimes for taxing minerals and petroleum mining. These royalty regimes were reviewed in 2012 against the principles outlined in Box 9.2, with various changes being implemented as a result of those reviews (MBIE 2012).

96. The fiscal impact of any further changes to the petroleum and minerals royalty regimes could be relatively small. Royalties from petroleum and minerals mining were approximately $200 million in 2017-18, or 0.2% of core Crown revenue.[36] The Group was informed that in the absence of any new discoveries, revenues are forecast to decline in the coming years, reflecting declining petroleum production volumes, and the decision not to grant further exploration permits for offshore petroleum mining.

97. The Group is not considering further changes to these royalty regimes.

Distributional impacts and equity considerations

98. Environmental taxes can increase the cost of essential goods, such as energy, food and transport. Low income households tend to spend a larger a share of their income on these goods than higher income households, and environmental taxes are therefore often assumed to be regressive (Kosonen 2012).

36 Estimated revenues in FY2017-18 from petroleum, minerals, coal and ironsands royalties, as well as energy resource levies on coal and gas - https://treasury.govt.nz/publications/ise/budget-2018-data-estimates-appropriations-2018-19. The Government collects additional revenue from mining operations from corporate income tax.

99. The actual incidence of environmental taxes will be highly dependent on a number of factors, including the consumption patterns of the taxed item, the availability of substitutes, and the extent to which additional costs can be passed on to the final consumer. If the revenue is recycled to assist affected parties transition to more sustainable practices, the impact is even less clear.

100. Insofar as taxes are successful in remediating environmental issues, the environmental impacts might also be progressive – lower income people can be disproportionately impacted by the degradation of the environment and ecosystem services.

101. The Group has not made detailed evaluations of these distributional issues for the pollutants and resources discussed above. However, the Group does not consider that potentially regressive impacts of environmental taxes is a sufficient reason in itself not to proceed with the approaches discussed in this chapter. Rather, the Government should be alert to potentially regressive impacts and seek to mitigate them as appropriate. Chapter 13 on *Personal income* outlines a number of options for increasing the progressivity of the income tax, which could also be used to offset any regressive impacts arising from the introduction of environmental taxes.

102. The Group is also mindful of the particular impacts that environmental taxes can have on Māori, and has included addressing Māori rights and interests as a key design principle for environmental tax instruments. Submissions to the Group by Māori organisations highlighted a range of viewpoints and concerns.

Summary of options for the short-to-medium term

103. Table 9.2 below summarises the performance of the five resources and pollutants the Group wishes to highlight against the negative externality framework.

Table 9.2: Evaluation of environmental tax opportunities in the short-to-medium term

	Greenhouse gases	Water pollution*	Water abstraction**	Solid waste	Road transport***
ESSENTIAL ATTRIBUTES					
Measurability	✓	✓ / ✔	✔	✔	✓
Behavioural responsiveness****	✓	✓	✓	✔	✔
Risk tolerance	✔	✓	✓	✔	✔
Sufficient scale	✔	✔	✔	✔	✔
DESIRABLE ATTRIBUTES					
Diversity of response	✔	✓ / ✔	✓	✔	✓
Revenue raising potential	✔	✓	✔	✓	✓

✔ Largely met / high ✓ Partially met / medium – Not met / low

* Overall assessment of key water pollutants (nitrates, phosphates, sediment and pathogens).

** Water abstraction taxes might be considered for the purposes of taxing natural resource use, rather than pricing negative externalities, which could make some of the above criteria redundant.

*** Overall assessment of key unpriced road externalities, including congestion.

**** Assessment of short term behavioural responsiveness. May be greater over the medium-to-long term.

	Greenhouse gases	Water pollution	Water abstraction	Solid waste	Road transport
DESIGN PRINCIPLES					
Māori rights and interests		!	!		
Distributional / equity impacts	!	!	!	!	!
Externality cost pricing	!			!	
Localisation of pricing		!	!		
International linkages	!				

! Priority issue

Longer-term possibilities: an environmental footprint tax

104. There are significant environmental challenges in New Zealand that our frameworks suggests are currently less well suited to environmental taxes. These tend to be environmental problems where activities driving environmental change are more challenging to measure, and therefore less well suited to the use of tax instruments. For example, biodiversity loss, and impacts on ecosystem services.

105. The Group received several submissions highlighting new approaches that could be developed to address some of these challenges. For example, an environmental footprint tax is a form of land tax, set according to the intensity of land use and consequent impact on the environment.

106. Discussions with submitters highlighted that significant further work is likely needed to better validate approaches like this, calibrate prices with externalities, and work through integration of other environmental taxes. Nonetheless, the environmental footprint tax is one example of the potential for new environmental tax instruments in the longer term.

Tax concessions

Care of the land

107. Several submitters suggested that costs associated with the care of land subject to a QEII covenant should be treated as deductible expenses. The submitters argued that deductibility would support the purpose of the QEII covenant regime, as well as reduce compliance and administration costs. The Group agrees with this suggestion. The Group also recommends that privately incurred costs associated with the care of Ngā Whenua Rāhui should also be tax deductible.

Agricultural concessions

108. The Group is aware of a number of existing tax concessions for agriculture in the Income Tax Act. Where a tax concession is shown to be degrading natural capital, there may be grounds for its removal. In these instances, there may be a case for Government support to manage the transition. There may also be a case to consider incentives for activities that generate environmental benefits.

109. The Group will explore these issues further in the Final Report.

Car parking and public transport

110. The Group has also considered the treatment of car parks and public transport. At the moment, the provision of free car parking to employees is not subject to fringe benefit tax. Yet any contributions made to an employee's public transport costs are taxed. This treatment has the perverse impact of discouraging the use of public transport.

111. The Group acknowledges the practical difficulties involved in applying fringe benefit tax to employee car parks. In recognition of this constraint, the Group suggests that the Government examine the possibility of allowing employers to subsidise public transport use by employees without incurring fringe benefit tax.

Revenue recycling

112. The Group considers there is a strong case to recycle some or all of the revenue from environmental taxation into measures that support the transition to a more sustainable economy. The Group is considering whether support should extend to those impacted by changes to existing tax settings where current settings are found to be negatively impacting on natural capital.

113. Recycling environmental tax revenue has several benefits. It can reinforce the purpose of the tax by funding complementary activities, as is done with the Waste Disposal Levy which is used to fund waste minimization projects. It can address equity concerns arising from the uneven incidence of the tax. It can also support fiscal transparency, demonstrating that the tax is being introduced for environmental reasons, and not to raise money for general government expenditure.

Summary

9.1 There is scope for tax instruments to play a greater role in delivering positive environmental and ecological outcomes in New Zealand. Environmental tax instruments can be a powerful tool for ensuring people and companies better understand and account for the impact of their actions on the ecosystems on which they depend.

9.2 Taxes are not well suited to all environmental problems and regulation will still be a better approach for dealing with some issues. Our draft framework identifies a range of criteria and design principles for environmental taxes to be effective. Environmental taxation and regulation should be considered together for positive outcomes.

9.3 In the short term, there may be benefits in expanding the coverage of the Waste Disposal Levy, and for reassessing waste and landfill disposal externalities to see if higher rates are warranted. There could also be benefits from strengthening the ETS and advancing congestion charging. Over the medium term, there could be benefits from greater use of tax instruments to address challenges in both water pollution and water abstraction. Addressing Māori rights and interests in fresh water should be central to any changes. In the longer term, new tools could allow for an expanded role for environmental taxes to address other challenges such as biodiversity loss and impacts on ecosystem services.

10

Corrective taxes

1. Corrective taxes are taxes that are primarily intended to change behaviour that is judged to be undesirable and/or to ensure individuals take into account the costs of their behaviour. They can therefore be contrasted with revenue taxes which are primarily intended to raise revenue with the least impact on taxpayer behaviour (and accordingly minimise deadweight costs or the economic cost of raising the tax).

2. If policymakers wish to stop undesirable behaviour, then a ban on the behaviour is likely to achieve their objectives faster, and with greater certainty, than a tax. This is because individuals may be willing to pay a corrective tax in order to continue to behave in the same undesirable way, or switch to a different type of behaviour that is just as undesirable. However, a ban may be impractical to enforce, in which case a tax, or another instrument, might provide a second-best policy solution.

3. Suitable policy responses to limit undesirable behaviour or to ensure that individuals face the full costs of their behaviour might be to regulate directly (for example to ban smoking where third parties are affected), impose tax, or provide better information. The relative effectiveness of each option will depend on:

   - how individuals respond to each option;
   - whether policymakers have information on how individuals respond; and
   - whether policymakers can tailor each option to individuals' responses.

4. Chapter 9 focused on corrective taxes as a means to address negative environmental externalities. This chapter deals with non-environmental corrective taxes. It focuses on alcohol, tobacco and sugar taxes – which are the most widely applied types of corrective taxes, and were also the subject of most public submissions on corrective taxes.

Alcohol

5. The main tax on alcohol in New Zealand is alcohol excise.[37] Alcohol excise is levied on alcohol that is manufactured in or imported into New Zealand; it raised $1 billion in 2017. The rates of alcohol excise vary by product type and alcohol volume. Some rates are applied on a *per litre* basis, while other rates are applied on a *per litre of alcohol* basis. Table 10.1 shows the rates for beer and certain wines and spirits.

6. The complex rates structure means there is considerable variation in the effective rate of excise per litre of alcohol. Figure 10.1 illustrates the effective rates for beer and certain wines and spirits at different alcohol volumes.

7. The duty-free concession represents one notable exemption from alcohol excise. The concession allows travellers to bring up to 4.5 litres of wine and beer and three bottles of spirits into New Zealand free of excise, provided they are for personal use or gifts.

37 The Government also applies the Health Promotion Agency levy on alcohol. This levy raised $12 million in 2017. Revenue from the levy is hypothecated to fund the Health Promotion Agency.

Assessment

8. The appropriate rates of alcohol excise will depend on an assessment of the health effects of alcohol consumption, and of the externalities associated with alcohol abuse. Accordingly, the Group believes the rates would be best decided with appropriate input from the public health community.

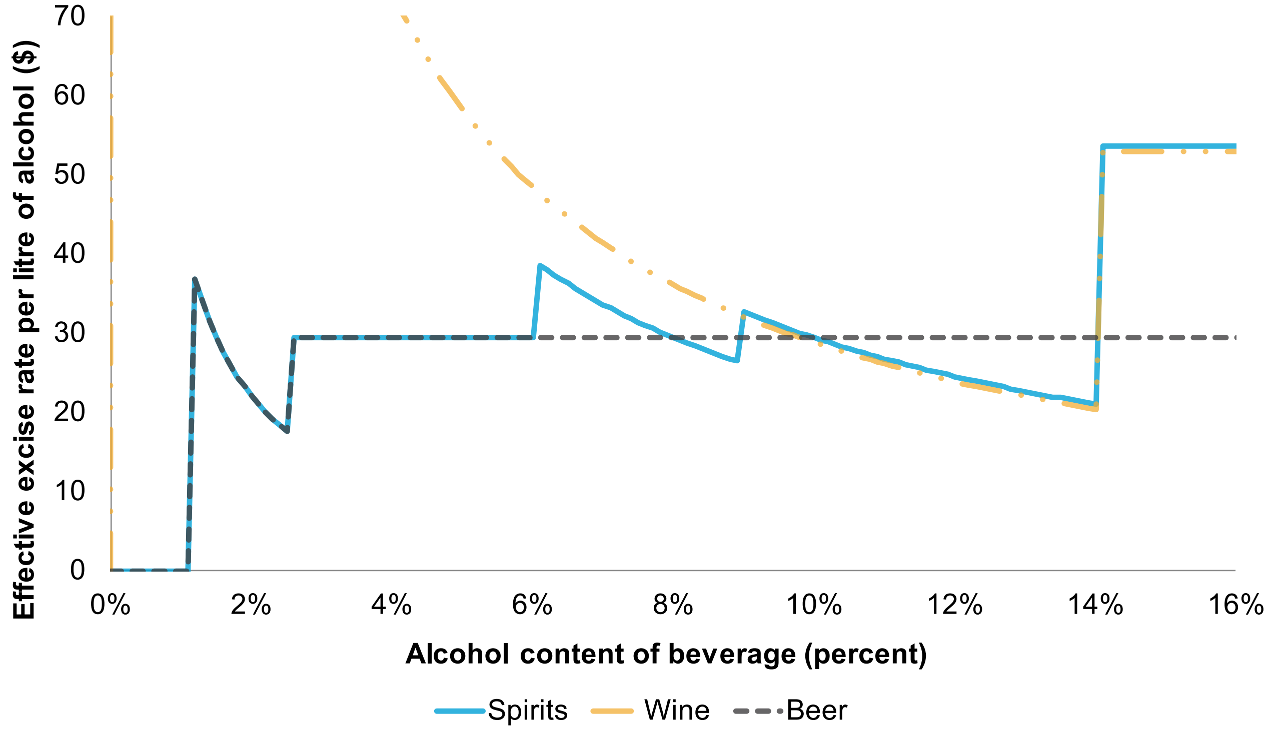
9. It is evident, though, that the current rate *structure* is unnecessarily complex. It is difficult to understand why the rates of excise per litre of alcohol should vary so much across different products. A case could be made for applying a consistent rate per litre of alcohol across all products – which would increase rates for some products and decrease them for others – but little can be said in favour of the current approach. The Group recommends that the Government review the rate structure with the intention of rationalising and simplifying it.

Table 10.1: Alcohol excise rates, effective from 1 July 2018

Beer	Containing more than 1.15 % vol., but not more than 2.5 % vol.	$0.44140 per litre
	Containing more than 2.5 % vol.	$29.432 per litre of alcohol
Wine	Containing more than 14 % vol., fortified by the addition of spirits or any substance containing spirit	$53.605 per litre of alcohol
	Other	$2.9432 per litre
Spirits	Containing more than 1.15 % vol., but not more than 2.5 % vol.	$0.44140 per litre
	Containing more than 2.5 % vol., but not more than 6 % vol.	$29.432 per litre of alcohol
	Containing more than 6 % vol., but not more than 9 % vol.	$2.3545 per litre
	Containing more than 9 % vol., but not more than 14 % vol.	$2.9432 per litre
	Containing more than 14 % vol.	$53.605 per litre of alcohol

Source: The Treasury

Figure 10.1: Effective rate of excise per litre of alcohol, (2018)



Source: The Treasury

Tobacco

10. Tobacco excise is levied on tobacco manufactured in or imported into New Zealand. Tobacco excise rates have increased by 10% above inflation each year since 2010, and are scheduled to increase by 10% above inflation each year until 2020. The excise raised almost $1.7 billion in 2017 – an increase of over 50% since 2010.

11. The duty-free concession allows travellers to bring up to 50 cigarettes or 50 grams of cigars or tobacco products into New Zealand free of excise, provided they are for personal use or gifts.[38]

Assessment

12. As with alcohol excise, the appropriate rates of tobacco excise will depend on an assessment of the health effects of tobacco consumption, and of the externalities associated with tobacco use. A full assessment of these issues is beyond the expertise of the Group.

13. Nevertheless, the Group is concerned about further large increases to the excise rates. There are three main reasons for sounding this caution:

    - Tobacco excise is regressive. There is a substantially higher prevalence of smoking in the poorest areas of our country (New Zealand Health Survey 2016/17). Although increases in the rates of excise may encourage some individuals to cease smoking, the heaviest burden of the excise increases will be borne by low income earners who continue to smoke.
    - The effectiveness of excise increases appears to be reducing. Regulatory impact analysis prepared by the Treasury in 2016 indicates that reductions in smoking prevalence are expected to be quite small relative to the size of the increases in the excise rates (Treasury 2016).
    - High taxes on tobacco appear to be a factor in an increasing number of robberies and criminal activity.[39]

14. The Group believes the Government should therefore prioritise other measures to help people stop smoking (such as educational campaigns and regulatory measures) before considering further large increases in tobacco excise rates. Some of the revenue from tobacco excise could also be directed towards smoking cessation programmes.

Sugar taxes

15. Several countries tax sugared products. In recent years, taxes on sugary drinks have become increasingly common. Table 10.2 below lists some examples.

16. Some countries also tax sugary foods. For example, in 2011, Hungary introduced a tax on certain foods deemed to be unhealthy, including sweets, biscuits, and bakery items (Berridge and Marriott, 2017).[40]

Table 10.2: Sugary drinks taxes in selected countries and cities

France	Sugar-sweetened beverage tax introduced in 2013. Rate of €7.53 per hectolitre.
Ireland	Sugar-sweetened drinks tax introduced in 2018. Rates of €16.26 per hectolitre for lower sugar drinks and €24.39 per hectolitre for higher sugar drinks.
Mexico	Tax on non-alcoholic drinks containing added sugar introduced in 2014. Rate of 1 peso per litre.
UK	Soft drinks industry levy introduced in 2018. Rates of 18 pence per litre for lower sugar drinks and 24 pence per litre for higher sugar drinks.
Berkley, USA	Sugar-sweetened beverage tax introduced in 2014. Rate of 1 cent per ounce.

38 The duty-free concession was sharply reduced from 200 cigarettes, 50 cigars, or 250 grams of tobacco products in 2014.

39 See, for example, comments by the New Zealand Association of Convenience Stores at https://www.tvnz.co.nz/one-news/new-zealand/dairy-industry-head-says-tobacco-tax-increases-making-smokes-more-and-sought-after-thieves

40 Other countries have also introduced taxes on fatty foods. For example, Denmark introduced a tax on food high in saturated fat in 2011, but this was repealed in 2012 due to concerns over complexity and avoidance (Berridge and Marriott, 2017).

17. The Group has received many submissions calling for the introduction of sugar taxes in New Zealand.

Assessment

18. The case for the introduction of a sugar tax (or a tax on sugar-sweetened beverages) must rest on a clear view of the goals the Government is seeking to achieve, and the effectiveness of taxation as a means to achieve those goals.

19. A report by NZIER has identified the five steps that must be achieved in order for a sugar tax to be effective:

> 1. Imposing a tax must increase the price of the targeted item.
> 2. The increase in price must lead to a reduction in consumption of the item.
> 3. Reducing consumption of the item must lead to a reduction in sugar and/or energy intake.
> 4. Lower energy intake must result in lower physiological risk factors.
> 5. Lower physiological risk factors must improve health outcomes.
>
> (Wilson and Hogan 2017)

20. When considering these five steps, the Group felt that a major risk with a sugar tax is that it will encourage consumers to switch to cheaper or untaxed products that are similarly unhealthy. So, while a sugar tax will reduce the consumption of some sugar products, the extent to which it generates any improvement in health outcomes will depend on what individuals decide to consume instead.

21. The Group feels this is an area that would benefit from a clear articulation of the Government's goals:

    - If the Government wishes to reduce the consumption of sugar across the board, then a sugar tax is more likely to be an effective response.

    - If the Government wishes to reduce the sugar content of particular products, on the other hand, then regulation is more likely to be more effective.

22. Once these goals have been clearly articulated, the Government should also consider whether there is a role for other policy responses, such as education.

Gambling taxes

23. A number of taxes currently apply to gambling, including totalisator duty, lottery duty, gaming machine duty, casino duty and the problem gambling levy. The Group is not aware of these taxes having been reviewed recently, and has not seen a statement of their purpose. The Group feels this is another area that could benefit from a clearer statement of the Government's goals, and a clearer view of the role of taxation relative to other measures such as regulation and education.

Summary

The Group:

10.1 Recommends that the Government review the rate structure of alcohol excise with the intention of rationalising and simplifying it.

10.2 Recommends that the Government prioritise other measures to help people stop smoking before considering further large increases in the tobacco excise rate.

10.3 Recommends that the Government develop a clearer articulation of its goals with regard to sugar consumption and gambling activity.

11

International income tax

1. The Group has received many submissions about international taxation, and the tax practices of multinational companies and digital firms. It is clear from the submissions that many people feel a deep sense of unfairness about the way in which the tax system deals with these firms. This is a worrying phenomenon: perceptions of unfairness have the potential to erode public support for the tax system as a whole.

2. Many submitters commented on the international tax reforms related to the Base Erosion and Profit Shifting (BEPS) agenda. The Group acknowledges these submissions, but notes that the Terms of Reference rule out detailed consideration of matters relating to the BEPS agenda, which is currently on the Government's Tax Policy Work Programme.

3. The Group's discussions have focussed instead on issues related to the taxation of cross border revenues from digital services, where some of the sharpest concerns about the taxation of multinational companies have arisen. It is currently an area of significant international attention – and significant international dispute.

4. The value of cross-border digital services provided into New Zealand is estimated to be approximately $2.7 billion in 2018, and this market is expected to continue growing.[41]

The current approach to international income taxation

5. New Zealand's ability to tax non-residents on their New Zealand sales income is determined by our domestic tax rules, in conjunction with the double tax agreements that we sign with other countries.

6. Double tax agreements override domestic rules, and New Zealand cannot change its double tax agreements without the consent of the other countries that are party to those agreements.

7. Double tax agreements allow New Zealand to tax non-residents on their business income from New Zealand under two conditions: if a non-resident has a sufficient taxable presence in New Zealand; and to the extent that their business income is attributable to that presence.

8. A **taxable presence** will arise if a non-resident carries on their business through a 'permanent establishment' in New Zealand. The definition of a permanent establishment requires the non-resident to be either physically present in New Zealand, or to have certain relationships with agents who are carrying on important parts of their business here.

41 MBIE (2017) estimates that the New Zealand market for cross-border digital services had a value of $0.5 billion in 2015. Shopify (2018) estimates the global business-to-business online market to be 234% of the business to consumer market. Applying the Shopify assumption to the MBIE estimate gives a total market size for cross-border digital services provided into New Zealand of $1.67 billion in 2015 (and $15.7 billion for all online goods and services). MBIE (2017) also assumes that the market for cross-border services is increasing by 18% per annum. Assuming this growth over the three years to 2018, the market size for cross-border digital services is estimated to be $2.74 billion in 2018.

9. It is also necessary to determine how much business income can be **attributed** to the permanent establishment in New Zealand. This requires an assessment of the value contributed in New Zealand to the non-resident's total income, compared to the value contributed overseas. The attribution of income ensures the taxing rights over a company's income are shared fairly between all of the countries in which the company operates.

10. Double tax agreements ensure that New Zealand businesses that make sales outside New Zealand are not exposed to double taxation. They also provide mechanisms, such as the exchange of information, that allow for the better enforcement of tax laws on inter-jurisdictional transactions.

11. New Zealand businesses and Inland Revenue benefit from operating within this international rules-based framework. Although the rules constrain our policy choices to some extent, New Zealand benefits overall from having and operating within this framework, as long as we can ensure the constraints are acceptable.

Challenges to the current approach

12. While they have worked quite well for trade in physical goods and services, they may not give a fair or sustainable tax outcome when applied to modern digital services that are supplied across borders.

13. The main issue is that the current rules largely allocate income on the basis of labour and capital employed in a jurisdiction. If a firm generates significant income from a jurisdiction but has little physical presence in that jurisdiction, it will have little or no labour or capital – and little or no income – allocated to that jurisdiction. With the increasing importance of intellectual property, the rules may be seen as increasingly not reflecting the economic reality of where income is actually generated.

14. Within this context, there are three main challenges to the existing framework:

    - **'Scale without mass'.** Digital companies can transact with customers over the internet without having the physical presence required by double tax agreements for income tax to be charged in the country. This allows digital companies to derive significant income from a country without paying local income tax, and provides them with an advantage over their domestic competitors. It also threatens the sustainability of the tax base, and reduces public perceptions of the fairness of the tax system.
    - **User value creation.** Even if a non-resident digital company does have a permanent establishment in a country, the profit attribution rules do not recognise the new kinds of value that are generated by digital companies in the countries in which they operate. These companies derive significant value from the active participation of their users, from data generated by the users, and from network effects. None of this value is recognised by the current profit attribution rules.
    - **Intangible assets.** Much of the value of digital companies can be attributed to intangible assets. These intangibles are hard to value. They are also mobile, meaning the income attributable to them can be easily moved to low tax jurisdictions.[42]

15. These three issues affect the provision of both goods and services. However, they are most pressing with regard to the provision of digital services with significant user value creation in New Zealand, since New Zealand is a net importer of these types of services. New Zealand is an exporter of other types of goods and services, so New Zealand exporters benefit from the current international framework. For this reason the Group has focused solely on the treatment of digital services involving user value creation. However we recognise that the problem is wider and recommend that New Zealand authorities should continue to seek ways to resolve both the digital and the broader issues.

42 The challenges associated with intangible assets are a broader issue, and not just limited to digital companies.

16. It is also important to recognise that these tax issues relate to income tax, rather than GST. GST has been applied to all 'remote' services since 2016 – including digital services involving user value creation – and the Government is currently finalising its preferred approach for collecting GST on low-value imported goods.

Potential responses

17. There are two broad ways to address the income tax challenges associated with digital services involving user value creation. One option is to change the current international income tax framework, for example by expanding the definition of a permanent establishment and amending the profit attribution rules. The other option is to apply a separate tax to certain digital supplies.

18. The OECD is providing a forum for international discussion of the issues through its *Inclusive Framework* process. A common multilateral approach, involving the amendment of the international income tax framework, would be best for a small country such as New Zealand. At the time of writing, however, there is disagreement between countries about the best way forward. Countries have committed to reaching a consensus on solutions by 2020, but achieving consensus will be challenging.

19. In the meantime, the European Commission and the UK have announced their support for an 'equalisation tax' as an interim measure. The EU Commission is proposing to levy a new 3% tax on gross revenues from certain digital services where local users play a major role in value creation. These services are the hardest to capture with current tax rules. The equalisation tax is arguably a very rough proxy for income tax on the presumed net profit margin derived by the supplier from the cross-border digital service. The tax would not apply to the supply of goods or services more generally, and would be removed if agreement on a more principled multilateral solution was reached at the OECD.

20. An equalisation tax would be a way to collect some tax from some digital companies that have been paying little tax in New Zealand or overseas. It would also help to signal the increasing urgency of the problem, and New Zealand's determination to find a solution. However, there are risks associated with the introduction of an equalisation tax. New Zealand would need to assess whether such a tax was consistent with our international trade obligations. In the current global political environment, we would also need to assess the risk of retaliation by other countries (resulting in additional foreign taxes being imposed on New Zealand's export sector), and whether those risks could be mitigated.

21. To mitigate the trade risks, and be consistent with other countries, an equalisation tax in New Zealand would need to be narrowly focussed on digital services that involve active user contribution and value creation in New Zealand. It would not apply to goods and services more broadly, as these would remain subject to the current international tax framework.

22. The other matter to consider is whether an equalisation tax will actually be paid out of the profits made from New Zealand by the digital suppliers, or whether the additional cost will be passed on to New Zealand consumers through higher prices for the digital services. The sense of unfairness from New Zealanders around the taxation of cross border digital revenues will not be addressed if the result of the equalisation tax is, in effect, the collection of more tax from New Zealand consumers.

23. The issues with taxing digital services also apply to sharing platforms, such as Uber and Airbnb. New Zealanders benefit from these platforms and, like the digital economy, they represent an opportunity for New Zealand (including the opportunity to develop new technologies that enhance natural capital). This chapter has focussed on the issues associated with taxing the sharing platforms themselves; Chapter 15 discusses the issues associated with taxing the New Zealand tax residents who use sharing platforms.

Assessment

24. New Zealand is very well-represented at the OECD, and the Group agrees strongly that New Zealand should continue to participate in the OECD's *Inclusive Framework* process.

25. Nevertheless, while international agreement is desirable, New Zealand should also be ready to act in its own best interests. Alongside participation in the *Inclusive Framework* process, the Government should ensure it is also ready to implement an equalisation tax, if the case for such a tax arises.

26. The introduction of an equalisation tax should depend on three key conditions:
    - A critical mass of other countries also adopting an equalisation tax. (The actions of Australia will be particularly important for New Zealand.)
    - New Zealand companies not being unduly affected by the tax.
    - The tax not simply being passed on to New Zealand consumers.

27. The desirability of moving in this direction will depend on international developments in the next six to twelve months. New Zealand will need to actively monitor these developments to determine the best way forward.

28. New Zealand should also ensure – to the extent possible – that our double tax agreements and trade agreements do not restrict our taxation options in these matters, and that future agreements are free of any existing restrictions on the use of effective options.

Summary

The Group:

11.1 Supports New Zealand's continued participation in OECD discussions on the future of the international tax framework.

11.2 Recommends that the Government be ready to implement an equalisation tax if a critical mass of other countries (including Australia) move in that direction.

11.3 Recommends that the Government ensure, to the extent possible, that our double tax agreements and trade agreements do not restrict our taxation options in these matters.

12

GST and financial transaction taxes

1. GST is a broad-based tax on consumption in New Zealand. GST is imposed at a single rate of 15% across a broad base of goods and services, with few exceptions.[43] The design of GST aims to raise revenue efficiently by taxing all goods and services equally, so that it does not affect consumer decisions regarding which goods and services to purchase.

2. GST was introduced in 1986 as part of wide-ranging tax reform. Tax revenue at the time relied heavily on income tax, which featured rates of up to 66%, as well as many rebates and reductions. The introduction of GST formed part of a series of measures to broaden the tax base. GST allowed for the removal of inefficient sales taxes, and for reductions in income tax rates; it reduced the tax system's reliance on revenue from income taxes.

The role of GST in the tax system

3. GST has proved to be a stable and efficient tax base. There have been no significant fluctuations in GST revenue since introduction, and the rules themselves have remained consistent (although there have been two increases to the rate of GST).

4. There are two main reasons why GST is such an efficient source of revenue:
   - As a consumption tax, GST is a way of raising significant amounts of revenue without the saving and investment biases that arise from income taxation.
   - GST has a broad base. In fact, New Zealand has one of the broadest GST bases among OECD countries. This allows New Zealand to raise large amounts of revenue from GST, even though the rate of the tax is not particularly high relative to other countries. The broad base of New Zealand's GST is one of its greatest strengths.

5. GST appears regressive when compared against current income. Lower-income households generally have lower saving rates than higher-income households. This means lower-income households will consume a greater proportion of their current income and, therefore, face a greater cost from GST. Higher-income households have higher saving rates, and consume less in the current period as a proportion of their income.[44] [45]

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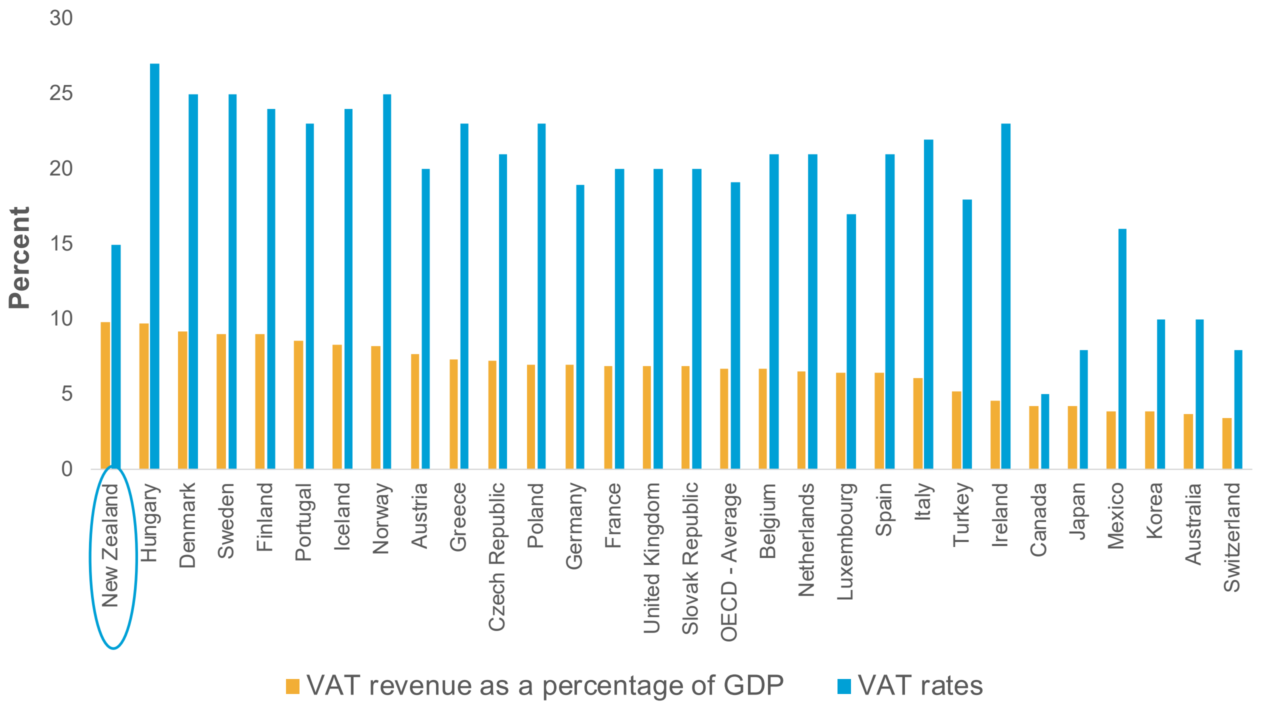
43 The main exceptions are residential accommodation and financial services.

44 GST appears less regressive when compared against lifetime income. Income generally rises as a person ages (up to a point), so GST will represent a greater share of a person's income when they are younger (and earning less), but a lower share of their income when they are older (and earning more). Retired people generally consume more than their income, and thus will pay more GST as a share of their income. From a lifetime perspective, the most recent research describe the impact of GST as 'either proportional or at worst slightly regressive' (Thomas 2015).

45 GST also applies to non-residents who consume goods and services while visiting New Zealand. As a result it applies a tax to non-residents who may otherwise not pay any New Zealand taxes.

Figure 12.1: Valued added taxes as a percentage of GDP, 2015



Source: OECD

The appropriate rate of GST

6. The Terms of Reference exclude consideration of an *increase* in the GST rate, but the Group has received many public submissions arguing for a *reduction* of the GST rate. Most submitters have argued that GST places a heavy burden on low-income earners, and that a reduction in the GST rate would increase the progressivity of the tax system.

Policy considerations

7. For the purposes of policy analysis, the Group has considered the implications of a reduction in the GST rate from 15% to 13.5%. This would reduce revenue by approximately $2 billion *per annum*.

8. Given the substantial loss in revenue, a key judgement is therefore whether a GST reduction represents the most effective way to address distributional concerns, relative to other potential uses of the revenue.

Distributional impacts

9. By any measure, a reduction in the rate of GST will deliver a greater dollar benefit for higher-income households. Figure 12.2 shows that the greatest benefits in dollar terms, by far, will accrue to households in the highest income decile.

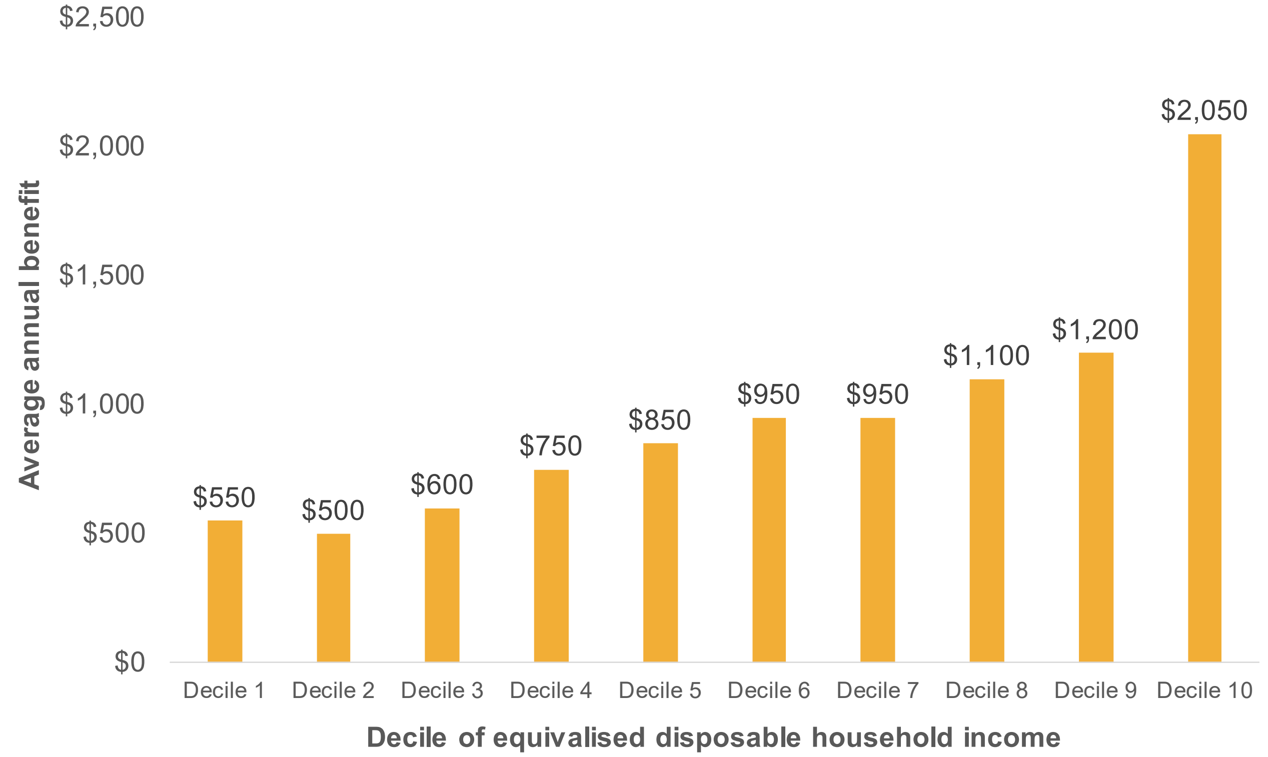
10. Figures 12.3 and 12.4 compare the benefits of decreasing the GST rate to 13.5% against two illustrative changes to the personal tax scale that have the same fiscal cost of $2 billion per year and are targeted towards lower income households:

    - The introduction of a tax-free threshold of $7,000. (Tax currently applies to the first dollar of income.)
    - A reduction of the first marginal tax rate from 10.5% to 5.25%.[46]

11. Figure 12.3 shows the benefits in dollar terms, and Figure 12.4 shows the benefit in terms of percentages of gross income.

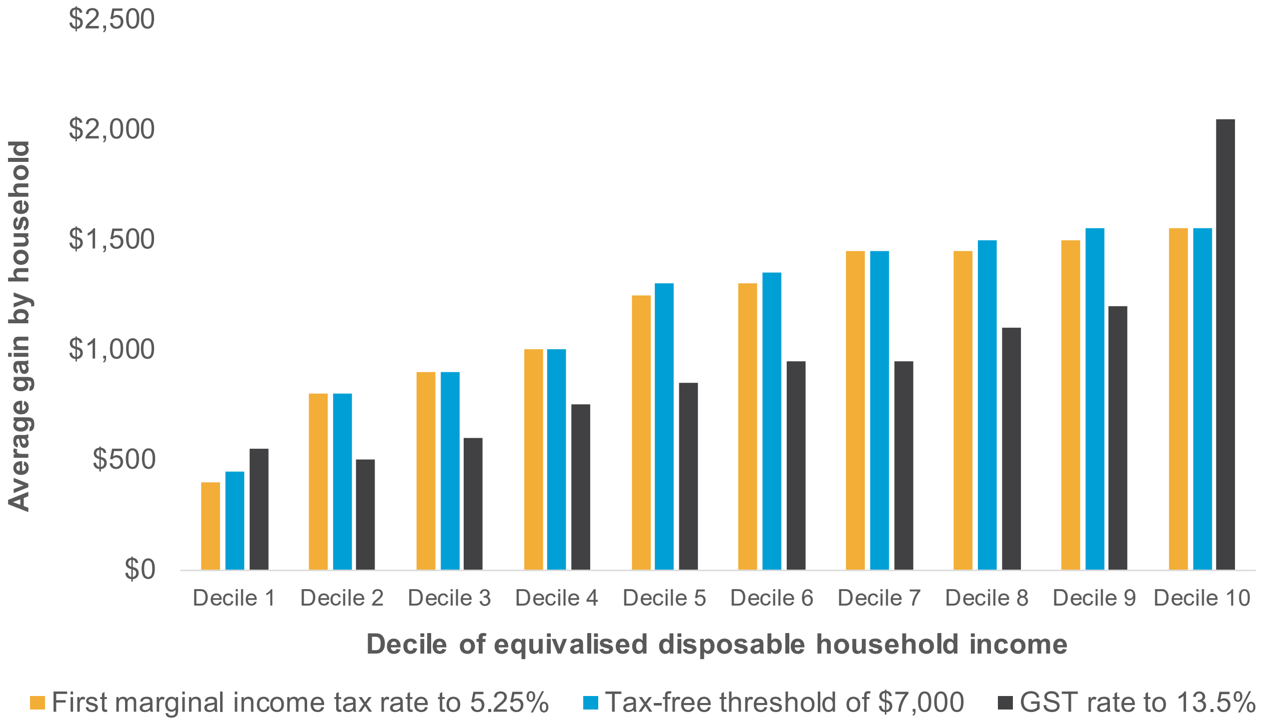
46 These estimates are preliminary and presented for indicative purposes only.

Figure 12.2: Average annual benefit for households of decreasing the GST rate to 13.5%



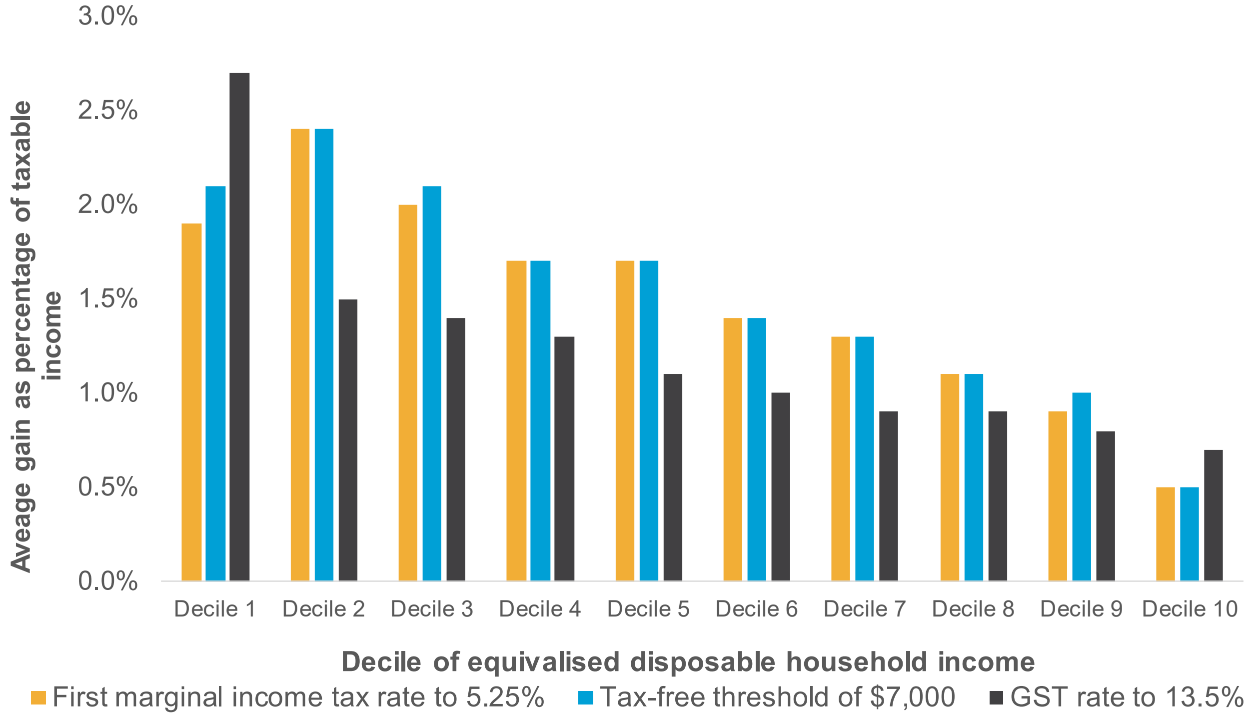
Source: Statistics NZ (HES 2015/16) with subsequent TWG Secretariat calculations. TWG Secretariat calculations done using Treasury's micro-simulation model of the tax and welfare system.

Figure 12.3: Annual benefit of rate reductions, 2015/16



Source: The Treasury. Estimated using Treasury's micro-simulation model of the tax and welfare system.

Figure 12.4: Benefit in terms of percentage of gross income, 2015/16



Source: The Treasury. Estimated using Treasury's micro-simulation model of the tax and welfare system.

12. As a percentage of income, when compared with these income tax changes, reducing the GST rate to 13.5% will provide:

    - Greater benefits to households in the lowest income decile.[47]
    - Less benefits for households in deciles 2-9.
    - Significantly greater benefits to households in the highest income decile.

13. The distributional benefits of reducing the GST rate are not particularly compelling, compared to the redistribution that is possible at a similar cost by reducing the lowest income tax rate, or by introducing an income tax free threshold.

GST and wealth inequality

14. A GST rate reduction is also a poorly-targeted measure if there are policy concerns about wealth inequality. This is because a reduction in the GST rate will provide a windfall gain in real value to those with existing wealth on the day the rate is reduced.

Interactions with the transfer system

15. All else equal, a reduction in the rate of GST will produce a one-off decrease in the inflation rate. Some welfare benefits are indexed to inflation, and so those benefits will increase less than would otherwise be the case following the change to GST.

Assessment

16. The Group does not recommend a reduction in the GST rate. However, the Group does recognise there is considerable public concern regarding the regressive nature of GST. In recommending against a reduction in GST, the Group's purpose is not to deny these concerns, but rather to point out there are more effective ways to address the issue. A GST rate reduction would have a high fiscal cost and is poorly targeted towards low and middle income households.

    - If the Government wishes to improve incomes for very low income households, the best means of doing so will be through welfare transfers.

47 The greater impact on decile 1 households arises from the fact that these households have high consumption relative to reported income (perhaps because they are receiving income that is not captured in survey data, such as help from their families or because they are borrowing to pay for their living costs). For this reason, outcomes for decile 2 households are likely to give a better indication of the impacts for very low income households (Perry 2017).

- If the Government wishes to improve incomes for certain groups of low to middle income earners, such as full-time workers on the minimum wage, then changes to make personal income taxes more progressive may be a better option.

17. The personal income tax system is explored further in Chapter 13 on *Personal income and the future of work*.

Exceptions to GST

18. The Group has received a large number of submissions arguing for various exceptions to the GST base. Some submitters have argued for exceptions in order to promote certain outcomes (such as encouraging the purchase of healthier food and drink). Other submitters are concerned about the distributional impact of GST, and have argued for exceptions on certain household items that are more likely to be purchased by low-income households.

Policy considerations

19. As a practical way of understanding the trade-offs involved in GST exceptions, the Group has assessed the implications of removing GST from food and drink (excluding alcoholic beverages).

20. Expenditure patterns differ across income bands. Expenditure on food and drink represents approximately 19% of the average weekly household expenditure of a household in decile 2, versus only 14% of the average weekly household expenditure of a household in the highest income decile. As Figure 12.5 illustrates, removing GST from food and drink will have a proportionally greater impact on lower income households.

21. Yet higher income households will derive a greater *dollar* benefit from the removal of GST on food and drink. (Higher income households spend more money on food and drink overall, even though this expenditure represents a smaller proportion of their total income.) The Group estimates that the removal of GST on food and drink will benefit a household in the highest income decile by $53.03 per week, whereas a household in the second lowest income decile will benefit by $14.35 per week.[48]

22. The key judgement, then, is whether GST exceptions represent the most efficient means to achieve society's distributional goals, relative to other measures such as income tax progressivity or direct welfare transfers.

Box 12.1: Windfall wealth gains from GST reductions

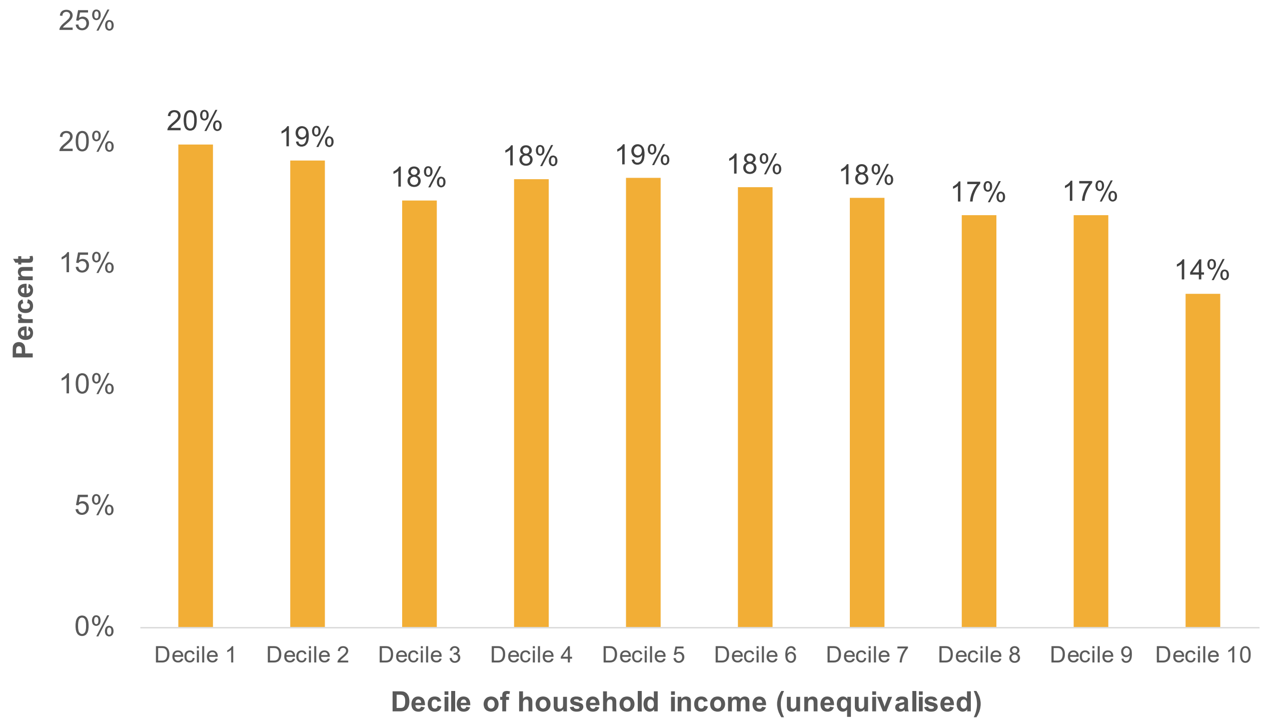
Take a person who has $1,150 in savings. If the average price of a good is $11.50 (including $1.50 of GST), then this person's savings can buy 100 average goods.

If GST is reduced from 15% to 10%, and the GST exclusive price of the good remains the same, the average price of a good will be $11 (including GST), and the person will be able to acquire 104 of these goods with their $1,150 of savings.

The reduction in GST provides the person with a windfall gain through an increase in the purchasing power of their existing savings.

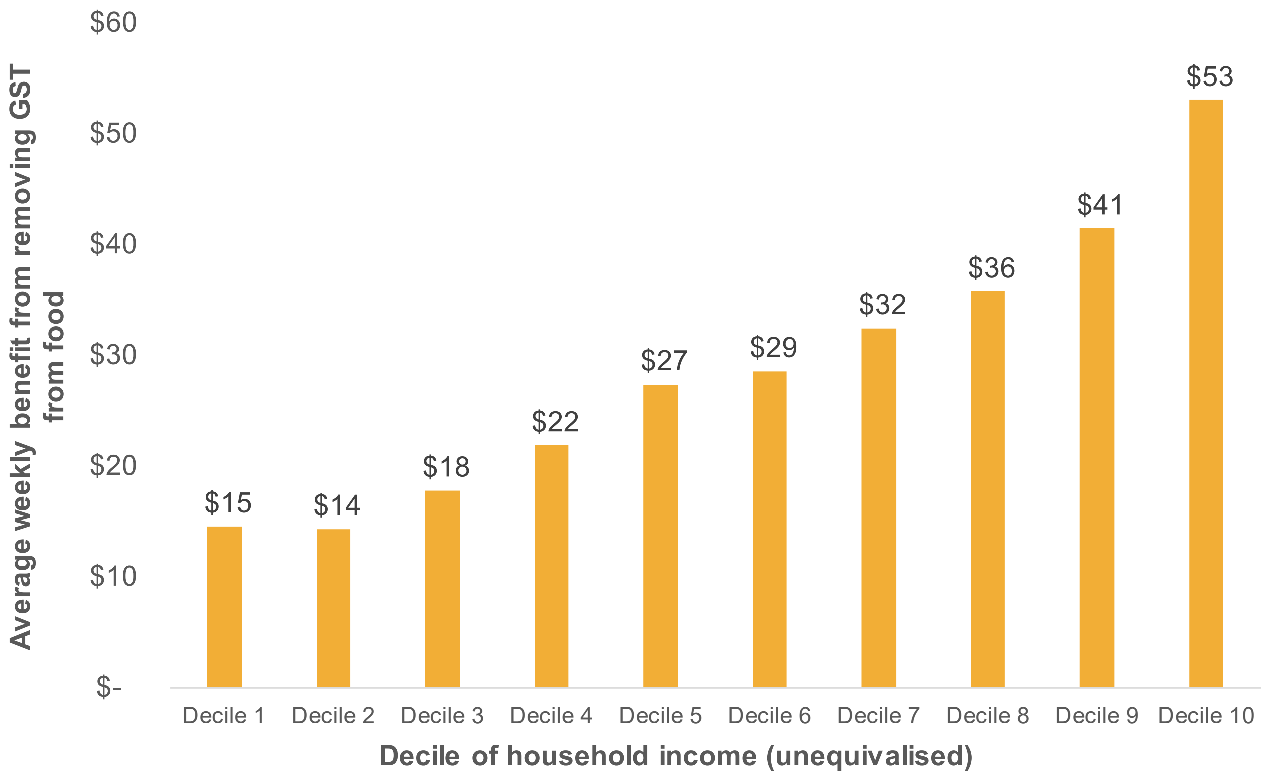
48 This estimate is based on static impacts. It does not account for any behavioural change arising from the removal of GST on food and drink. The estimate also assumes that all of the benefits pass through to consumers. This outcome may not arise in practice.

Figure 12.5: Expenditure on food and drink by households, 2015/16[49]



Source: Statistics NZ (HES 2015/16) with subsequent TWG Secretariat calculations.

Figure 12. 6: Weekly benefit for each income decile of removing GST from food and drink, 2015/16



Source: Statistics NZ (HES 2015/16) with subsequent TWG Secretariat calculations.

49 This excludes alcoholic beverages.

23. There are good reasons to believe that GST exceptions are an inefficient means to achieve distributional goals:

- The revenue foregone from GST exceptions could be used instead to fund more targeted support for low income households. For example, the Group estimates that an exception for food and drink will reduce GST revenue by $2.6 billion. If the Government had the same amount of money to spend on redistribution, it could fund a cash transfer to each household of $28.85 per week – doubling the cash benefit to households in the second lowest income decile. A more targeted transfer would provide even greater benefits to low income households at the same fiscal cost.[50]
- Providing exceptions through the GST system generally leads to complex and arbitrary boundaries. Boundaries create compliance costs, as businesses must identify and then separate out the products on which GST has been removed.
- If GST has been removed from one good or service, it becomes difficult to argue against further exceptions on similar grounds. Increasing numbers of exceptions will erode the GST base and require tax increases elsewhere to make up the lost revenue.

Assessment

24. The Group's judgement is that GST exceptions are a poorly-targeted mechanism to achieve distributional goals. GST exceptions are also complex and generate large compliance and administration costs. Other measures, such as welfare transfers, are likely to have greater benefits for the same fiscal cost.

25. Chapter 10 on Corrective Taxes also explores further the merits of using the tax system to incentivise behavioural change.

The GST treatment of financial services

26. Financial services are exempt from GST.[51] In principle, GST should apply to financial services, because they are services consumed in New Zealand. The reason for the exemption is a practical one: it is difficult to value these services, given that most financial institutions charge through interest rate margins, rather than fees.[52]

Policy considerations

27. The exemption of financial services is problematic. Financial services are under-taxed relative to other services, which is both unfair and subsidises the consumption of financial services. The boundary between exempt and non-exempt services is complex to administer and comply with.

28. The exemption also reduces revenue. The Australian Treasury estimates that Australia's GST exemption for financial services resulted in a loss of revenue of $3.2 billion for the 2016/17 financial year. This represented approximately 5.1% of Australia's total GST revenue in that year (The Australian Government, The Treasury 2018).

29. In terms of distributional impacts, the existing exemption benefits households that consume financial services, but the incidence of the benefits is unclear. Financial assets and liabilities are mostly held by high-income households, but financial institutions may earn higher margins on financial services to lower income households. Consequently, it is difficult to ascertain whether the exemption primarily benefits higher- or lower-income households.

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50 Studies that concur with this general finding include Ball *et. al.* (2014), Mirrlees *et al.* (2011) and OECD (2014).

51 Financial services to *consumers* are exempt from GST (i.e. they are input taxed). Financial institutions cannot claim GST back on inputs attributable to services to consumers (such as rent, advertising, computers or contractors). Financial services to *businesses* are zero-rated (i.e. they are GST-free). Zero-rating ensures that GST does not become a cost to business. Input taxing financial services to businesses could otherwise result in tax cascades, where GST is applied multiple times during the production process.

52 An interest rate margin is the difference between the interest rate charged to a borrower and the interest rate paid to a depositor.

30. The arguments in favour of applying GST to financial services are clear. The main challenge is whether there is a *feasible* means of doing so. The Group has considered a number options for addressing the issue:

    - **The cash flow method** – which would require GST-registered businesses (including financial institutions) to charge GST on all cash they received for financial services, and claim input credits for all cash they paid out for financial services. These cash flows would include the interest payments as well as principal and repayments of principal.
    - **The margin method** – which would require GST-registered businesses (including financial institutions) to calculate the financial margin for every financial transaction, and then apply GST to this margin.
    - **A financial activities tax** – which would tax financial institutions on the sum of their cash flow profit and wages. (This is a proxy for the application of GST).
    - **An apportioned financial activities tax** – which would tax financial institutions on the sum of their cash flow profit and wages, with the sum apportioned so that only the profit and wages attributable to consumer services was taxed. (This option is another proxy for the application of GST.)

31. All of these methods involve trade-offs. A financial activities tax is relatively simple to implement, but will impose significant efficiency and productivity costs. This is because it creates 'tax cascades' in which additional tax is imposed at each stage of the production process.

32. The other three options avoid tax cascades, but will be difficult to implement, administer and comply with. The Group is not aware of any other country that has successfully introduced these options. Even if these taxes were successfully implemented, there is a risk that some financial activity would simply relocate offshore in order to avoid the tax.[53]

33. An alternative approach would be to apply GST to the explicit fees charged for financial services. (GST on fees could also serve as an interim measure allowing time to develop a more comprehensive approach to the GST treatment of financial services.) This policy has been adopted in other countries, such as South Africa.

34. There are, however, some significant problems with this approach. The main problem is the ease with which financial service providers could switch from applying explicit fees to implicit fees (for example, by reducing or eliminating explicit fees and instead charging or offering a slightly different interest rate to consumers).

35. The Group also notes the possible distributional impacts of imposing GST only on explicit fees. Financial service providers appear to be more likely to charge explicit fees when the service they are providing cannot be effectively compensated for using implicit fees. For example, a bank may charge set fees for specific services, while providing a rebate from those fees if the balance of an account is large enough. Applying GST only to explicit fees could mean that individuals with low bank balances will be the ones most likely to pay the tax.

Assessment

36. The Group believes there is a strong in-principle case to apply GST to financial services, but there are no obviously feasible options for doing so. The Government should monitor international developments in this area.

Financial transaction taxes

37. A financial transaction tax is a tax on the purchase, sale, or transfer of financial instruments. A financial transactions tax could be considered a tax on the consumption of financial services.

38. Many submitters have recommended the introduction of a financial transactions tax, on the basis that it would discourage speculative trading, improve financial stability, and generate revenue from the financial sector.

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53 However, this risk can be over-stated. There have for a long time been incentives to move consumer financial activities offshore, for example to take advantage of international interest rate differentials much larger than those likely to be created by a financial services GST.

Policy considerations

39. While some economic theory suggests that these taxes can improve market stability, most empirical evidence suggests that imposing additional transaction costs on financial markets either increases (or at least has no impact on) price volatility. In practice, financial transaction taxes appear to deter too much productive short-term trading to successfully achieve an outcome of reduced market volatility.[54]

40. These taxes have been able to raise a reasonable amount of revenue in other countries. Yet the revenue potential of a financial transactions tax in New Zealand is likely to be limited, due to the ease with which the tax could be avoided by relocating activity to Australian financial markets.[55] Any relocation will also reduce the size of New Zealand's capital markets.

41. There will be various distributional impacts from a financial transactions tax. Groups and sectors that regularly trade financial assets will pay a high share of the tax. Part of the cost will be borne by the owners, managers and employees of financial institutions, and part by the consumers of financial services. Savers will pay a particularly high share of the tax. Some of the cost may also be borne by New Zealand workers if the tax increases the cost of capital. Nevertheless, international research indicates that a financial transactions tax is likely to be progressive (Burman et al. 2016).

Assessment

42. A financial transactions tax is an inefficient tax that is unlikely to raise significant revenue for New Zealand. The Group recognises that there is active international debate on such taxes, which should be monitored, but does not recommend the introduction of a financial transactions tax at this point.

Low-value imported goods

43. The Group was asked to consider options for the application of GST to low-value imported goods.

44. The Group agrees that, in principle, GST should be collected on low-value imported goods. The non-collection of GST results in competitive disadvantage and unfairness for domestic retailers, and results in an increasing amount of lost revenue for the Government.

45. The Group wrote to the Ministers of Finance and Revenue in February 2018 with the following recommendations for the treatment of low-value imported goods:

- The Government should implement an offshore supplier registration model to collect GST on imported goods from suppliers who exceed the GST registration threshold.
- The *de minimis* for collection of GST by Customs should be changed to a $400 threshold based on the good's value but should not be increased beyond that point.
- The Government should consult on the proposed offshore supplier registration model to ensure it is effective.
- Options for collecting GST between the point of sale and delivery and for payment of GST after delivery should continue to be reviewed to see if the practical issues with them can be overcome and become an effective means of collecting GST on low-value goods, in particular from unregistered suppliers.

54 Studies of the impact of financial transactions taxes include Baltagi et al. (2006), Colliard & Hoffmann (2017), Gomber et al. (2016), Pomeranets et al. (2013), Roll (1989), Umlauf (1993), and Liu & Zhu (2009).

55 The successful relocation of financial transactions could reduce the efficiency costs of the tax by allowing mutually beneficial trades to proceed – albeit in a different jurisdiction.

46. In May 2018, the Government began public consultation on the following approach to the treatment of low-value imported goods:

- Offshore suppliers would be required to register, collect, and return New Zealand GST on goods valued at or below $400 supplied to New Zealand consumers.
- The rules would apply when the good is outside New Zealand at the time of supply and is delivered to a New Zealand address.
- Offshore suppliers would be required to register when their total supplies of goods and services to New Zealand exceed $60,000 in a 12-month period. In certain circumstances, marketplaces and re-deliverers may also be required to register.
- Tariffs and border cost recovery charges would be removed from goods valued at or below $400.
- The current processes for collecting GST and other duty at the border by Customs will continue to apply for goods valued over $400.
- The current border processes for managing risks in relation to imported goods, including biosecurity assessment, will remain in place.

47. Consultation closed in June 2018 and final policy consideration is currently underway. The Group understands that the Government intends to implement the new regime from 1 October 2019.

Summary

The Group:

12.1 Recognises the significant public concern regarding GST, but does not recommend a reduction in the rate of GST. This is because lowering the GST rate would not be as effective at targeting low- and middle-income families as either:

- welfare transfers (for low income households); or
- personal income tax changes (for low and middle income earners).

12.2 Does not recommend the removal of GST from certain products, such as food an drink, on the basis that the GST exceptions are complex, poorly targeted for achieving distributional goals, and generate large compliance costs.

12.3 Believes there is a strong in-principle case to apply GST to financial services, but there are significant impediments to a workable system. The Government should monitor international developments in this area.

12.4 Does not recommend the application of GST to explicit fees charged for financial services.

12.5 Recognises that there is active international debate on financial transaction taxes, which should be monitored, but does not recommend the introduction of a financial transactions tax at this point.

The Group has already reported to Ministers on the issue of GST on low-value imported goods, and the Government is advancing that work.

13

Personal income and the future of work

1. Personal income tax is the largest source of revenue for the Government. It is also – alongside GST – the primary way in which most New Zealanders interact with the tax system. The fairness and integrity of the income tax regime therefore bears directly on New Zealanders' views of the fairness and integrity of the tax system as a whole.

2. Previous chapters on Capital and wealth, Retirement savings, and Housing affordability have dealt with specific aspects of the income tax regime. This chapter addresses the underlying structure of the income tax – its rates and thresholds – and explores how New Zealand's approach to personal income taxation may need to adjust to changes in the world of work.

The current approach to personal income taxation

3. Personal income tax applies to individuals. It is the ultimate tax paid by individuals after income has worked its way through the various taxable entities and structures, taking the form of wages, salaries, self-employed income, dividends, interest and other income.

4. Unlike the other tax bases, personal income tax has a progressive rate structure. The current rates and thresholds are as follows:

Table 13.1: Income tax rates and thresholds

Taxable income	Tax rate
Up to $14,000	10.5%
Over $14,000 and up to $48,000	17.5%
Over $48,000 and up to $70,000	30%
Remaining income over $70,000	33%

5. Most personal income tax is collected from employees. Employees do not receive any deductions for work-related expenses. (Nor are they required to register for GST.) Income tax on employee salaries and wages is withheld at source, so most employees do not need to file a tax return.[56]

6. Non-employees – whether operating as a business or as a contractor – receive the opposite treatment. They receive deductions for work-related expenses, and generally need to register for GST. There are, however, various levels of withholding tax on some contractors.

7. Common law tests determine the employment status of an individual for tax purposes. Consequently, the taxable status of an individual may differ from their contractual status.

The rates and thresholds of income tax

8. The Group has received a large number of submissions on the rates and thresholds of income tax. The Group is still weighing its options in this area, but the Terms of Reference do rule out consideration of any *increase* in income tax rates.

56 Some employees, however, are subject to an 'end-of-year square up' for other items, such as social policy entitlements.

9. The Group's objective in considering change is to enhance the living standards of New Zealanders, particularly for those on low incomes. The Group's deliberations over the coming months will thus be informed by several key metrics:

   - The distributional impact of options for change – including judgements on how options for change affect the progressivity of the tax system, and whether taxes or transfers are the best option for improving the living standards of lower income households.
   - Impacts on incentives to save, work, and invest.
   - The extent to which options increase or reduce the integrity of the tax system.
   - The revenue impacts of options for change.

10. Nevertheless, as noted in Chapter 12 on GST, the Group can say at this point that reductions to the lower tax rates and/or thresholds would be the most progressive means of assisting low and middle income earners through the tax system. If the Government wishes to improve incomes for very low income households, on the other hand, the best means of doing so will be through welfare transfers.

11. The Group also believes that income tax reductions should benefit all low income households – including households on benefits. At the moment, some benefits are set to ensure that beneficiaries receive a given level of income *after* tax. Any tax reductions will need to be paired with equivalent increases in benefit levels to ensure a fair treatment of all income earners.

12. The Group is not considering a reduction in the top marginal tax rate of 33% because the rate is already low by international standards and the Group does not wish to reduce the progressivity of the tax system on vertical equity grounds.

Bracket creep

13. The Group has received some submissions expressing concern about 'bracket creep' in the tax system. Bracket creep occurs when inflation increases people's incomes, moving them into higher tax brackets. It causes individuals to pay more in tax, even though their real earnings (measured in purchasing power) have not increased.

14. Annual changes to rates and thresholds impose compliance costs on individuals and businesses. The Group believes that bracket creep is best dealt with through the periodic review of the rates and thresholds of income tax to ensure they remain appropriate rather than some form of indexation.

Assessment

15. The Group will provide recommendations regarding the rates and thresholds of income tax in the Final Report in February 2019.

The future of work

16. The preceding sections of this chapter have dealt with personal income taxation as it currently stands. But we all know that change is coming to the way we work – if it is not already here.

17. The world is living through a period of intense innovation: digital technology is transforming established business models and altering traditional relationships between business and workers. As with other sectors of the economy, technology has the potential to disrupt existing paradigms in taxation too. Combined with globalisation, generational demographics and climate change, there may be significant challenges for our workforce in the future.

18. It is impossible to predict how these changes will affect the future labour force in New Zealand. It is possible there will be an increase in the number of jobs in New Zealand, but it is equally possible that we see a decrease in the number of workers required in the future. This may be especially so in the market for low skilled workers.

19. Some submitters asked the Group to consider a universal basic income in response to the possibility of falling employment. However, the Group considers that this falls outside its terms of reference and is more appropriately considered by the Welfare Expert Advisory Group.

20. Some commentators have proposed what has been described as a 'robot tax' to replace lost taxes on wages, to address the problem of the automating firms transferring the costs of employment loss onto society, and to counter resulting increased inequality (Delaney 2018). The Group considers that there are likely to be better ways for the tax and transfer system to address these problems if automation becomes more widespread in New Zealand.

21. It is important that the tax system remains sustainable and flexible for the changes that could occur before they occur to ensure that the tax base is protected. This may include a higher reliance on other taxes rather than personal income tax.

The 'gig economy' and the rise of the contractor

22. In the *Submissions Background Paper*, the Group discussed the role of the gig economy in the changing nature of the work. The gig economy is a labour market characterised by a prevalence of short-term contracts or freelance work, as opposed to permanent employment. Workers in the gig economy have less regularity in their sources of income, working hours and conditions, and often operate as contractors.

23. There are a number of reasons why the gig economy could be expected to grow in the future:

    - **Business drivers.** Businesses face a range of costs and obligations when they hire permanent employees. Faced with these costs, businesses may prefer to rely on a flexible workforce that can be hired on an as-needed basis. Businesses may also prefer greater flexibility when they require specialist skills for specific projects.
    - **Personal drivers.** Some (but not all) workers may prefer to work as contractors on the basis that self-employment provides them with a greater sense of freedom and flexibility. For many, the reason is simply to earn extra income. Past regulatory reforms have made it easier for individuals to establish companies and set themselves up in self-employment.
    - **Technological drivers.** The development of online technology 'platforms' – such as *Freelancer, Uber and MyCare* – has made it much simpler for individual contractors to connect with potential employers.

24. *Uber* may be a household word, but, at least so far, the statistics appear to be lagging behind our lived experience. According to Stats NZ, the proportion of self-employed workers has remained relatively steady over the ten years to 2016 (SNZ 2016).

25. These outcomes could change quickly, although the evidence is at times contradictory. In the UK, for example, the share of the workforce that is self-employed has grown by a quarter since 2001 (Sidhu 2018), but it has fallen in most other OECD countries (OECD 2018). It has also been predicted that the majority of the workforce in the United States will be freelance by 2027, with 47% of millennials in the United States freelancing now, though others have challenged this (Upwork 2017, EPI 2015).

26. The timing and impact of these trends are uncertain. The challenge for New Zealand is thus to future-proof the tax system, so it can cope with rapid change in the nature of work, as and when it arises.

PAYE and the sustainability of the income tax base

27. The current approach to income tax collection is an artefact of the 1950s. Most income tax from labour is collected through the PAYE system, which was introduced in 1958. PAYE – or 'pay-as-you-earn' – is a withholding system in which employers are responsible for deducting and paying income tax on their employees' behalf.

28. PAYE may be long in the tooth, but it is an extremely efficient means of collecting tax. PAYE results in high levels of compliance among employees, and while imposing some compliance and administration costs on employers, it results in lower compliance and administration costs to the system overall and so is the most efficient means of collecting the tax.

29. Yet its effectiveness as a revenue collection tool depends on the predominance of formal employee/employer relationships in the workforce. As the proportion of self-employed workers rises, the effectiveness of PAYE as a revenue-raising tool reduces.

30. This is because the rise of the contractor poses a number of risks to the income tax base:

- **Integrity.** The self-employed are generally less compliant than workers in an employee/employer relationship because they have a greater ability to under-report income or inflate expenses (Cabral and Gemmell 2018). There is also a group of vulnerable self-employed workers who may not comply with their tax obligations because they lack the necessary skills or knowledge to do so.
- **Administration costs.** It is more efficient for Inland Revenue to deal with larger employers than with individual contractors. All else equal, administration costs will rise as the number of contractors rises (although new platforms and technology may partially offset the increase in costs).
- **Compliance costs.** The costs of compliance must be shouldered entirely by individuals, rather than by their 'employers.'

31. There are also issues of equity and fairness. Employees generally do not file tax returns, and their employer is responsible for KiwiSaver and ACC obligations, along with some social obligations such as student loan or child support payments. A self-employed person, on the other hand, must account for their own taxes, as well as KiwiSaver, ACC, and their social obligations. They may also be required to register and account for GST.

32. This can result in a situation where two people sitting across from each other – essentially doing the same role – can end up with very different tax obligations.

Options for responding to this challenge

33. The Group has considered how best the tax system can respond to the rise of the contractor. As a starting point, the Group acknowledges that the Government has already introduced a number of measures to increase compliance by the self-employed, which have had the effect of increasing the scope of the withholding regime.[57]

34. The Group also understands that Inland Revenue is exploring a range of further measures to increase compliance by the self-employed:

- Increased information reporting to Inland Revenue by both payers and platforms (such as ride-sharing companies). International evidence suggests that compliance increases when taxpayers know the revenue authority is receiving information on payments received (IRS 2007).
- The potential extension of withholding taxes by payers and platforms. Inland Revenue is currently considering the most effective approach for applying withholding to areas of high non-compliance.
- Making better use of technology platforms, for example by allowing those platforms to deal with individual contractor's tax obligations by deducting tax from payments received and paying this through to Inland Revenue (e.g. the use of smart accounts that directly account for tax as income is deposited).

57 These measures include: the addition of labour hire firms to the schedular payment rules; the removal of the company exemption from withholding tax for companies working through labour hire firms; the ability for contractors to choose a rate of withholding tax (with certain limitations); and the ability for contractors to have voluntary withholding tax deducted from payments (with the agreement of the payer).

35. It is important that Inland Revenue supports these measures with continued use of data analytics and matching information to specific taxpayers to identify underreporting of income.

36. This work overlaps with some of the proposals outlined in Chapter 15 for improving the integrity of the tax system.

Assessment

37. The Group supports Inland Revenue's efforts to increase the compliance of the self-employed. The Group particularly supports an expansion in the use of withholding taxes as a means to reduce individuals' compliance costs and increase compliance, and recommends that withholding be extended as far as practicable, including to platform service providers. The Group also supports changes to facilitate platforms to assist the self-employed meeting their tax requirements through the use of smart accounts or other technology based solutions.

38. The Group also recommends two further actions. Firstly, the Group recommends a review of the existing GST treatment of contractors. The current approach of applying GST to contractors who are essentially supplying the same services as an employee which are not subject to GST appears to impose compliance costs for little benefit.

39. Secondly, it has also become apparent to the Group that there is a risk of quite different definitions of employment status, including particularly 'employee' and 'dependent contractor', being used across Government. The Group recommends that the Government seek, where possible, to align these definitions for tax and employment purposes.

The treatment of childcare costs

40. Childcare can be a significant cost of earning income for the parents of young children, and the responsibility for childcare tends to fall disproportionately on women. The labour force participation of mothers – and particularly of low income mothers – is therefore sensitive to changes in childcare costs (Knox 2012).

41. In light of these challenges, some submitters have argued that the tax system should assist with childcare costs in order to increase labour force participation among mothers

Policy considerations

42. Some countries allow childcare costs to be fully or partly deductible; New Zealand does not. New Zealand's approach reflects a longstanding principle of tax law that expenditure of a private or domestic nature is not tax deductible.

43. The Group believes there is a valid case for the Government to provide additional support for childcare costs. The issue considered by the Group is whether this support is best delivered through the tax system, or through other policy vehicles.

44. There are, in fact, a number of disadvantages associated with the deductibility of childcare expenses. Because of the progressive tax scale, childcare deductions will provide a greater benefit to individuals in higher-income brackets than individuals in lower-income brackets. There is some evidence that the labour force participation of higher-income mothers is also less sensitive to changes in childcare costs than lower-income mothers (Knox 2012). If so, childcare deductions may not be the most cost-effective way to increase labour force participation.

45. One option for targeting support to low- and middle-income families could be a specific tax credit, similar to the donations tax credit. However, introducing a new type of credit would add to compliance costs for individuals and to administrative costs for Inland Revenue.

Assessment

46. The Group agrees with submitters that additional support for childcare costs is desirable, but believes this support is best provided outside of the tax system. The Group would support instead the extension of direct Government support for childcare.

Summary

The Group:

13.1 Will provide recommendations regarding the rates and thresholds of income tax in the Final Report in February 2019.

13.2 Supports Inland Revenue's efforts to increase the compliance of the self-employed, particularly an expansion of the use of withholding tax as far as practicable, including to platform providers such as ride sharing companies.

13.3 Supports the facilitation of technology platforms to assist the self-employed meet their tax obligations through the use of smart accounts or other technology based solutions.

13.4 Recommends that Inland Revenue continues to use data analytics and matching information to specific taxpayers to identify underreporting of income.

13.5 Recommends that there be a review of the current GST requirements for contractors who are akin to employees.

13.6 Recommends that the Government seek to align the definition of employee and dependent contractor for tax and employment purposes.

13.7 Recommends additional Government support for childcare costs, but believes this support is best provided outside the tax system.

14

The taxation of business

1. Company tax is an important part of our revenue base. But the taxation of business also has a broader impact on wellbeing. It directly affects the accumulation of physical and financial capital, because it changes the incentives on firms and individuals to save and invest. From a human capital perspective, business tax can affect the incentives for firms to create employment and invest in the skills of their workers. Through all of these channels, business tax can ultimately influence the productivity of the economy.

2. There is an important link between social capital and the taxation of business. Business taxation helps to sustain public trust and confidence in the tax system; it buttresses the personal income tax by reducing opportunities for wealthier individuals to reduce their tax obligations. Ineffective and unfair business taxation, on the other hand, will erode public acceptance of the prevailing levels of taxation, as well as the spirit of voluntary compliance by taxpayers that underpins efficient tax collection.

3. There are also links between business and natural capital. Business activities can affect stocks of natural capital; business can also have a positive role in preserving and enhancing the natural environment.

4. This chapter explores some of the key features of the taxation of business, with a particular focus on company tax.

The current approach to the taxation of business

Taxable entities

5. Businesses are taxed depending on the entity they choose to operate through. There are many types of taxable entities – including sole traders, partnerships, look through companies, and Māori authorities, among others. All of these entities, however, are variations on three basic structures:

   - Individual/partnership treatment – where income is attributed directly to the individual owners, for example in the case of look-through companies and limited partnership rules.
   - Standard company tax treatment – where income is taxed initially at the company level, but ultimately at the individual owners' tax rate on distribution.
   - Trusts – where income is taxed as either trustee income or beneficiary income.

6. The tax system generally tries to ensure that consistent amounts of tax are paid on income earned through each of these different structures, unless there are good policy reasons to depart from consistency. The objective is to ensure, as much as possible, that taxpayers choose the structure that is best for business purposes, rather than for tax purposes.[58]

58 Chapter 15 on *Integrity* provides a number of recommendations to increase consistency in the treatment of these different structures.

The company tax regime

7. The most common form of business structure is the company. Companies pay company income tax on the income they generate: they claim expenses against their gross income to arrive at their net income, and then pay tax on the net income. Tax credits are also deducted as part of the tax payable calculation. The company tax rate is currently 28%.

8. Company dividends are subject to the imputation regime. The purpose of imputation is to prevent the double taxation of company income that is distributed as dividends. Imputation works in the following way:

   - Income earned in a company is taxed to the company at the company tax rate.
   - Dividends paid to shareholders are taxed to the shareholders as personal income.
   - An 'imputation credit' is deducted from the personal income tax paid on the dividend. The imputation credit is equal to the amount of company tax that has been paid on the dividend.
   - The net personal tax paid is the difference between the personal and company rates applied to the underlying income.

9. Imputation means that company tax is treated as a withholding tax for New Zealand shareholders when profits are distributed as dividends. Any income that is not taxed at the company level is taxed when it is received by the New Zealand shareholder. These effects are deferred until the income is paid out as a dividend.

10. For non-residents, final tax is paid at either the company rate (to the extent that company income tax has been paid), or at the applicable non-resident withholding tax rate (up to 15%), if company income tax has not been paid.

The merits of imputation

11. Many countries provide relief on the taxation of dividends to mitigate the risk of double taxation, but there has been a shift away from full imputation, particularly in European Union countries.[59] In light of these developments, the Group has considered whether the imputation system remains fit-for-purpose in New Zealand.

Policy considerations

12. A practical alternative to imputation is the 'classical system.' In a classical system, income earned through companies is taxed twice: income accruing to companies is taxed first at the company level, and then the profits distributed to shareholders are taxed at the personal level. One of the main benefits of a classical system is that it generates much lower compliance and administration costs than imputation.

13. There could also be an increase in capital investment overall if the introduction of the classical system involves a net reduction in company taxation. Greater capital investment could boost labour productivity and increase wages, although the extent of the impact is uncertain. The effects will likely be larger for non-resident shareholders, for whom company tax is the only tax they pay. However, a classical system creates a number of distortions, including disincentives to use equity finance and to distribute profits.

14. A classical system is also unlikely to increase progressivity in a consistent manner. It will increase progressivity with respect to the recipients of dividends (dividends are received across the income scale, but higher income-earners are more likely to receive dividends than lower income-earners). Yet there will be many ways to avoid the double layer of taxation – for example, through the use of shareholder salaries and bonuses, or through a greater reliance on debt financing.

59 This reflect a European Court of Justice ruling that imputation systems that only provide tax credits to domestic investors are discriminatory.

15. Some of these disadvantages can be mitigated by exempting the dividends received by shareholders. While this mitigates the double taxation of a classical system, it limits the taxation of corporate profits to the corporate income tax rate, which creates an incentive for the use of corporate structures.

Assessment

16. The Group does not see a compelling case to change the imputation system in light of the disadvantages associated with alternative approaches. However, the Government will need to revisit the merits of imputation if Australia moves away from its own imputation system.

The appropriate rate of company tax

17. The Group has received many submissions on the subject of the company rate, and has accordingly considered whether the current rate remains appropriate.

Policy considerations

Competition for foreign investment

18. New Zealand funds some of its capital stock from inbound investment, and will have a lower capital stock if tax represents an undue impediment on inbound investment. This could result in higher prices and lower wages, because workers are generally more productive when using more capital – although the effect depends on the form and nature of the investment.

19. Table 14.1 sets out the corporate tax rates in a range of comparator countries. New Zealand's current company tax rate is higher than average when compared with other OECD countries. After accounting for imputation, however, the total tax to a domestic shareholder is relatively low on a cross-country basis.

Table 14.1: Corporate tax rates, 2018[60]

Country	Rate
France	34.3%
Australia	30.0%
Belgium	29.6%
New Zealand	***28.0%***
Canada	26.8%
United States	25.8%
Norway	23.0%
Denmark	22.0%
Sweden	22.0%
Finland	20.0%
United Kingdom	19.0%
Ireland	12.5%

Source: OECD.

Table 14.2: Overall statutory tax rates on dividend income

Country	Rate
France	56.7%
Canada	55.6%
Denmark	54.8%
Belgium	50.7%
United Kingdom	49.9%
Ireland	48.4%
United States	47.5%
Australia	47.0%
Norway	46.6%
Sweden	45.4%
Finland	43.1%
New Zealand	***33.0%***

Source: OECD.

60 The table includes an average of subnational corporate rates where applicable, for example in the case of the United States.

20. Yet the risks associated with tax competition for foreign capital can be overstated. In general, an investment that is economic at a 28% rate will not become uneconomic simply because another country drops its own company tax rate. The Group acknowledges that there are differing views about the impact of a corporate income tax rate change on foreign direct investment. But the available evidence suggests that a modest reduction in corporate income tax rates does not necessarily lead to a meaningful increase in foreign direct investment.

21. The two most recent reductions in the company rate in New Zealand – in 2008 and 2011 – were not associated with an increase in foreign investment. In fact, the stock of foreign direct investment as a percentage of GDP trended down slightly in the following years. There was also no increase in the level of foreign investment relative to Australia, whose company rate was unchanged during that period.[61]

22. Many other drivers were affecting investment decisions during this period, including the effects of the Global Financial Crisis. Still, this experience raises questions about the extent to which minor reductions in the company rate will have meaningful impacts on the level of foreign investment in New Zealand.

Competition for tax bases and headquarters

23. Some New Zealand firms could also decide to relocate their headquarters to jurisdictions with lower corporate rates. This risk is mitigated by the fact that it is advantageous for New Zealand companies with substantial New Zealand shareholder bases to remain headquartered in New Zealand. Tax paid in New Zealand can be passed on as a credit to New Zealand shareholders; this is not possible for tax paid in foreign jurisdictions.

24. Yet a lower company rate – that is more aligned with the global average – would decrease the incentive for firms to shift profits into lower tax jurisdictions, and would require less reliance on New Zealand's transfer pricing and anti-avoidance rules (which are designed to mitigate this risk).

25. Overall, however, competition for the tax base and location of companies is likely to be more important in countries that are close alternatives to one another for the location of business activity. In Europe, for example, a business can supply many markets from any one of a number of countries. Business in Europe may therefore be highly sensitive to tax rates in their choice of location.

Modelling the impact of company tax rate cuts

The Tax Working Group Secretariat modelled the impacts of a reduction in the company rate at the request of the Group. The modelling suggests that a five percentage point cut in the company rate, funded by an increase in labour taxation, would have minimal impact on New Zealand's national income. These results are broadly consistent with modelling for Australia published by the Australian Treasury (Kouparitsas et al. 2016).

Some of the assumptions used by the Secretariat are open to criticism, and the Group acknowledges that the use of these assumptions may lead the model to overstate the national income benefits of a company rate cut.

The model has been subject to external independent review. While the reviewer made some criticisms of the model, and recommended some changes, they agreed that the case for a reduction in the rate appears to be weak, based on simple (but probably reasonable) modelling of foreign investment responses to company tax rates.

Further information on the results of the Secretariat model, and the external independent review of the model, are available at https://taxworkinggroup.govt.nz.

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61 New Zealand International Investment Position and Gross Domestic Product, Statistics New Zealand. OECD data on FDI stocks for Australia.

26. In this context, it will be important to monitor Australia's corporate income tax rate. If Australia adjusts its corporate rate, the Government will need to review whether New Zealand's company rate remains appropriate.

Incentives on domestic investors

27. New Zealand is a net importer of foreign capital, but access to domestic capital is critical for the growth of most local firms. In the Group's view, a reduction in the company tax rate is unlikely to have much of an impact on domestic investors. This is because the imputation system (with taxation at the shareholder level and a credit for company tax paid) will claw back the benefit of any company tax reductions for domestic investors sitting on the top personal rate.

Location-specific economic rents

28. A reduction in the company rate will reduce the taxation of location-specific economic rents. 'Rents' are returns over and above those required for investment in New Zealand to take place. They may arise from various factors, such as natural resources, or access to particular markets. There is an open question about the size of location-specific economic rents in New Zealand.

29. Economic rents are an efficient source of taxation, because they can be taxed without discouraging investment. Economic rents are particularly valuable when they are earned by non-residents, because New Zealanders will derive the benefit of the tax revenue, but will not affect decisions of non-residents of whether to invest or not.

The integrity and coherence of the tax system

30. A reduction in the company rate will reduce the integrity of the tax system, if it is not paired by a corresponding decrease in personal tax rates. High income earners will be more likely to shelter income in companies to avoid the top personal rate. The five percentage point differential between the company rate and the personal rates already encourages tax-sheltering; the rewards of doing so will only increase if the differential grows further. If a lower corporate income tax rate were introduced, specific anti-avoidance rules would need to be considered to mitigate this issue.

Assessment

31. There are countervailing arguments for and against a reduction in the company tax rate. A lower rate will reduce the incentive for companies to shift profits offshore, and may encourage greater foreign investment (although the extent of the increase in investment and national income as a result of a modest rate cut is highly uncertain). Yet a lower rate will reduce the taxation of economic rents (to the extent they are available), and further reduce the coherence and integrity of the tax system (unless the top personal rate is also reduced, which is the Group is not considering). Alternative productivity-enhancing options may be more attractive than a company rate cut.

32. As a result, the Group overall judges that the costs to the coherence, integrity and revenue potential of the tax system are likely to outweigh the uncertain benefits of additional investment, growth, and welfare. However, the Government should continue to monitor developments in company tax rates around the world, particularly in Australia.

A progressive company tax

Is there a case to introduce a progressive company tax?

33. Besides considering the appropriate rate of company tax, the Terms of Reference direct the Group to examine specifically whether a progressive company tax – with a lower rate for small companies – would improve the tax system and the business environment.

34. A progressive rate could be applied in a number of ways. For example, it could apply to business income below a certain threshold, or for a set number of years after a company has commenced business.

35. Australia introduced a progressive company tax in 2015. For 2018/19, companies with an aggregated turnover of less than $50 million will pay a rate of 27.5%. Companies above that threshold will pay a rate of 30%.

36. The Australian system was originally conceived as a temporary measure. The Australian Government intended to progressively extend the lower company tax rate to all corporate entities, by gradually increasing the turnover threshold each year.

Policy considerations

37. There are two main arguments for a progressive company tax: firstly, that small businesses will have more funds available to invest and grow; and secondly, that the progressive rate will compensate small businesses for the fact that fixed compliance costs impose a relatively higher burden on them.

38. There are, however, significant costs arising from a progressive company tax. One of the primary costs is a reduction in efficiency: the tax will favour firms on the basis of their size rather than their productivity. The tax will also reduce the incentive for firms to grow beyond the point at which the higher rate kicks in.

39. An increase in the differential between the company rate and the top personal income rate will also encourage tax minimisation and avoidance. The progressive rate will increase the incentive (which already exists) for individuals to access lower tax rates through small business vehicles; additional rules will be necessary to ensure that business owners cannot multiply their access to the low tax rate by breaking up their firms.

40. In any case, it is already possible for closely-held businesses to access progressive taxation through the look-though company structure, in which income is attributed to shareholders directly and taxed according to the progressive income tax scale.

41. The Group acknowledges submitter concerns about the impact of compliance costs, particularly on small businesses. It would seem more efficient, however, to focus on measures that directly reduce these costs, rather than provide indirect support for a subset of businesses through the tax system. Compliance cost reductions will benefit all firms – but they will benefit small businesses in particular.

Assessment

42. The Group notes that progressive taxation is already possible through the use of look-through company structures. Beyond this, the Group judges that the costs of a progressive company tax are likely to outweigh any benefits in terms of faster small business growth. A better approach for supporting small businesses would be to focus on reducing compliance costs.

43. The Group has identified several areas where the Government could take immediate action to reduce compliance costs. Some of the thresholds in the Income Tax Act have not been reviewed in some time. Depending on the fiscal position, the Government could consider measures such as:

- Increasing the $2,500 threshold for paying provisional tax to $5,000-$10,000.
- Increasing the $10,000 year-end closing stock adjustment to $20,000-$30,000.
- Increasing the $10,000 limit for the automatic deduction for legal fees, and potentially expanding the automatic deduction to other types of expenditure.

44. The Group does not consider altering thresholds around fixed assets (such as the low value write off threshold) should be considered as they can have large fiscal costs relative to the practical compliance cost reductions.

45. The Group also considered using an alternative basis of taxation for smaller businesses, such as a cashflow or turnover basis. The Group has not pursued these options due to the administrative and threshold issues they present.

46. The Group would like to explore further options for simplification and reducing compliance costs for small businesses, for inclusion in the Final Report.

The appropriate rate for Māori authorities

47. A Māori authority is a company or trust that elects to be treated as a Māori authority for tax purposes. Entities must meet certain criteria in order to be eligible for Māori authority status.

48. The Group received a large number of submissions on Māori authorities. Some submitters opposed the Māori authority regime; others supported the regime, but offered suggestions for improving the way in which it operates.

Policy considerations

49. In light of the debate around the Māori authority regime, it is worth revisiting what the regime does and how it works.

50. The current Māori authority rules (which have been in effect from the 2004-05 income year) were designed to address statutory or other legal restrictions on the ability to develop or trade assets held in collective ownership. These constraints are not faced by other trusts or companies with similar investments.

51. The Māori authority rules operate in a similar manner to the company imputation model. Māori authorities pay tax at a rate of 17.5%. The tax paid then forms a credit in its Māori Authority Credit Account. These credits can be attached to distributions to members, and the members can in turn use the credits to offset their individual tax liabilities.

52. The aim of the 17.5% rate is to reduce compliance costs for Māori authorities and their members. The rate is set at a level that is intended to reflect the most common marginal tax rate of the economic owners of Māori authorities; tax paid at the entity level is essentially a withholding mechanism for the final tax paid by Māori authority members.

The current rate

53. The Group has considered whether the current rate for Māori authorities remains appropriate. In 2010, when the rate was last reviewed, about 80% of Māori authority members had a marginal tax rate of 17.5% or lower, meaning they would have no additional tax to pay (or they could claim a refund).

54. The median annual income of Māori individuals is around $32,000 in 2018. This indicates that the majority of Māori authority members probably still have incomes below the $48,000 threshold, and indicates that the factors resulting in the 17.5% rate for Māori authorities remain relevant.

The treatment of subsidiaries

55. The wholly-owned subsidiaries of Māori authorities cannot elect to be treated as Māori authorities. This means the 17.5% rate applies only to the Māori authority itself, and not to its subsidiaries. The 17.5% rate can, however, be effectively accessed if the subsidiary distributes to the parent Māori Authority.[62]

56. Given the constraints created by the taxation rules, some Māori authorities have begun to use transparent structures, such as limited partnerships, to access the 17.5% rate for subsidiary businesses. The use of transparent structures is an appropriate structural choice as they focus on income being taxed at the ultimate member's tax rate.

57. Yet it is inefficient for entities to structure themselves to achieve a desired tax result, rather than because it makes the most commercial sense to adopt that structure. The current approach seems to run counter to the aims of the Māori authority regime.

Assessment

58. The Group recommends the retention of the 17.5% rate for Māori authorities. The Group also notes that the current treatment of subsidiaries is resulting in inefficient outcomes, and recommends that wholly-owned subsidiaries of Māori authorities be eligible for the 17.5% rate, perhaps by being treated as Māori authorities in their own right.

59. Submitters have also suggested a number of technical refinements to the Māori authority rules. The main suggestion is to apply a default 17.5% resident withholding tax rate for distributions from Māori Authorities.[63] The Group recommends that the Government investigate this and the other suggestions through the Tax Policy Work Programme.

Options for enhancing business productivity

60. The Group is currently considering a number of options that could enhance business productivity. These options include:

Loss continuity rules

61. Losses and income are treated asymmetrically under New Zealand's company tax system. Companies pay tax when their income is positive, but the Government does not provide a refund when income is negative. Instead, losses can be carried forward to offset any tax obligations associated with the future income of the company.[64]

62. The loss continuity rules determine whether losses from a previous year can be used in a future year. Generally, losses may be used to offset future income, unless more than 51% of the company's shares have changed hands since the losses were incurred.

63. The loss continuity rules require a balance between efficiency and integrity objectives. Strict rules can reduce efficiency by discouraging risk-taking, but loose rules may allow companies to reduce their taxable income by trading in losses.

64. The Group believes the existing loss continuity rules are appropriate for most companies, but may not be working well for small start-up firms. These firms require equity capital to grow, but are often inherently loss-making. The existing loss continuity rules may be constraining their ability to grow through additional equity capital. Any relaxation of the rules would need to be carefully calibrated to ensure that the change does not facilitate trading in losses among larger firms.

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62 The imputation credit at 28% meets the parent's tax liability at 17.5%, with the remainder converted into a tax loss. This outcome is arguably inefficient because Māori authorities incur a timing disadvantage that would not arise if the subsidiary was taxed at 17.5% in the first instance.

63 The default resident withholding tax rate is currently 33%, so Māori authority members on the 17.5% rate will be subject to additional taxation of 15.5% if they do not provide their IRD numbers and file a tax return. Since few members do so, this income is effectively overtaxed.

64 Alternatively, the losses can be used to offset the taxable income of other 'commonly-owned' companies (i.e. companies in which at least 66% of shareholders are the same as in another company).

Black hole expenditure

65. Black hole expenditure is business expenditure that is expected to result in an economic cost to a taxpayer, but is not deductible (either immediately or over time).

66. An example of black hole expenditure arises when a business incurs costs to investigate the feasibility of a capital project, but ultimately decides not to proceed with the project. In that case, the costs associated with investigating the feasibility of the project will not be deductible, and so the expenditure is said to have fallen into a 'black hole.'

67. The treatment of black hole expenditure is linked to the treatment of gains and losses on capital assets. The Group will develop firm recommendations on black hole expenditure in the course of its work on the extension of capital income taxation.

Building depreciation deductions

68. New Zealand abolished depreciation deductions for buildings in 2010, with effect from 2012. The Group is considering whether there is a case to reinstate depreciation deductions for certain types of buildings.

69. As noted in Chapter 8 on *Housing affordability*, the restoration of depreciation on multi-unit residential buildings could support the Government's housing affordability goals by increasing the supply of housing and supporting greater intensification in urban areas.

70. There may also be a case to reinstate depreciation deductions for commercial and industrial buildings, which depreciate faster than other types of residential buildings. The treatment of depreciation is closely linked to decisions on extending the taxation of capital income. This is because a reinstatement of building depreciation will reduce the likelihood (and size) of a capital loss on the disposal of a building.

71. Any changes to the treatment of building depreciation might need to be phased in over time to make the fiscal costs manageable, given their substantial cost, see Table 14.2.

72. The above costing is based on a system of 3% diminishing value tax depreciation. If buildings do not depreciate at that rate, the cost will be smaller over time, as depreciation deductions are clawed back as depreciation recovery income on sale.

Assessment

73. The Group will provide recommendations on these options in the Final Report in February 2019.

Table 14.2: Revenue impacts of reinstating building depreciation deductions

Building type	$m increase/(decrease)				
	2020/21	2021/22	2022/23	2023/24	2024/25
Industrial	(240)	(250)	(260)	(270)	(280)
Commercial	(510)	(525)	(545)	(565)	(590)
Multi-unit residential	(90)	(95)	(100)	(105)	(110)
Subtotal (Industrial, Commercial, Multi-unit Residential)	(840)	(870)	(905)	(940)	(980)
All other residential	(430)	(450)	(475)	(500)	(530)
All	(1,270)	(1,320)	(1,380)	(1,440)	(1,510)

These estimates are preliminary and presented for indicative purposes only.

Box 14.1: The treatment of seismic strengthening

In the course of discussions on building depreciation deductions, the Group has noted that no deductions are allowed for expenditure on seismic strengthening.

The current approach results in a counter-intuitive outcome: deductions may be claimed if a building collapses in an earthquake, but no deductions may be claimed on expenditure that will prevent the building from collapsing.

The Group is still considering its position on this issue, but it does seem to be an area where tax policy is working counter to the Government's disaster risk management agenda.

Summary

The Group recommends that the Government:

14.1 Retain the imputation system.

14.2 Not reduce the company tax rate at the present time.

14.3 Not introduce a progressive company tax.

14.4 Not introduce an alternative basis of taxation for smaller businesses, such as cashflow or turnover taxes.

14.5 Consider other measures to reduce compliance costs. Depending on the fiscal position, these measures could include:

- increasing the $2,500 threshold for paying provisional tax to $5,000-$10,000;
- increasing the $10,000 year-end closing stock adjustment to $20,000-$30,000;
- increasing the $10,000 limit for the automatic deduction for legal fees, and potentially expanding the automatic deduction to other types of expenditure.

14.6 Not change the thresholds around fixed assets.

14.7 Retain the 17.5% rate for Māori authorities.

14.8 Extend the 17.5% rate to the subsidiaries of Māori authorities.

14.9 Consider technical refinements to the Māori authority rules, as suggested by submitters, in the Tax Policy Work Programme.

15

The integrity of the tax system

1. Most New Zealanders recognise the importance of paying tax, and meet their tax obligations. Some, however, do not. Others, while meeting their obligations, do so in a way that means they pay less tax on their income than others in similar circumstances. Both have the effect of reducing the integrity of the tax system and ultimately eroding social capital if not addressed by government. It also means that compliant taxpayers must pay more to achieve a given level of revenue.

2. Four broad principles should buttress the integrity of the tax system:

   - **Income should be treated the same, regardless of the structure.** People who earn the same amount of revenue should pay the same amount of tax, regardless of the structure through which the income is earned.[65]

   - **All revenue should be reported.** Taxpayers should not be able to under-report or hide their income in the 'hidden economy.' Tax should be easy to pay and hard to evade.

   - **Inland Revenue has the capability to find and address integrity issues.** Integrity issues tend to be first identified by Inland Revenue's investigation arm. Inland Revenue must continue to invest in the technical and investigatory skills of its staff to ensure future integrity issues can be identified and addressed in a timely manner.

   - **Tax must be collected.** Taxpayers should not be able to escape their tax obligations through sheltering or structuring.

3. This chapter develops recommendations or options in support of all four of these principles. The first two sections – on trusts and closely-held companies – deal with integrity issues associated with particular types of structures. The following sections then explore measures to shed light on the hidden economy, improve tax collection and ensure Inland Revenue has the capability to find and address integrity issues.

Trusts

4. The Group has received a number of submissions on the taxation of trusts. Many submitters believe that trusts are being exploited to shelter income and avoid tax. Accordingly, the Group has looked carefully at the evidence to assess the impact of trusts on the integrity of the tax system.

The taxation of trusts

5. A trust is a legal relationship between people. It is not a legal entity in its own right. When a trust is established, one person (the 'settlor') gives property to another person (the 'trustee') to look after and use for the benefit of someone else (the 'beneficiary'). The relationship places legally enforceable obligations on the trustee to manage the property for the benefit of the beneficiary. A settlor may be a trustee and a beneficiary of a trust, but they cannot be the sole trustee and beneficiary.

65 This is all subject to the policy intent of the particular provision. For example the top rate for KiwiSaver and similar schemes is intentionally below the top tax rate for an individual.

6. The income generated by a trust falls into two broad categories. They are the income retained by the trust which is defined as 'trustee income,' and the income distributed to beneficiaries as 'beneficiary income.' In most discretionary trusts, the trustee decides how much of the trust's income is to be retained or distributed (although income must be distributed within a certain time period in order to be classed as beneficiary income).

7. Different tax treatments apply to these categories of income:
   - Trustee income is taxed at a final rate of 33%.
   - Beneficiary income is taxed at the beneficiaries' respective marginal tax rates.
   - Income distributed to children under the age of sixteen is subject to the 'minor beneficiary' rule and taxed at the trustee rate of 33%.[66]

8. Trust losses can be carried forward to offset the trust's future tax obligations, but cannot be used to offset the beneficiaries' individual tax obligations. They also cannot be used to offset income of other trusts with the same settlor or trustee.

Policy considerations

Past issues

9. Trusts became increasing popular during the 2000s, particularly in the small business sector. The use of trusts was a reaction to the structure of income tax at that time. Before reforms in 2009 and 2010, the top personal rate stood at 39%, whereas the trustee rate was 33%.

10. Since the trustee rate is a final rate, company owners were able to avoid the top personal rate by inserting a trust between themselves and the company. There was a substantial rise in the amount of trustee income between 2001 and 2011 as taxpayers arranged their affairs to take advantage of this benefit.

11. Subsequent tax reforms reduced the benefit of earning income through a trust structure. In 2010, the Government aligned the trustee rate with the top personal rate. Trustee income has fallen significantly since then.

12. There has also been a process in recent years to review the legislative framework for trusts. In 2010, the Law Commission launched a review of the law of trusts. Among other things, the Commission observed there was a perception that some trusts were used to thwart legal obligations.

13. The Law Commission concluded that it was necessary to update the guiding legislation to reinforce the principles underlying trusts and clarify the duties of trustees (LC 2013). Legislation to modernise trust law is currently before Parliament.

Current issues

14. Most trusts today are 'passive' – they hold the family home and have few other investments. The Group sees no major tax issues associated with passive trusts, particularly given the current alignment between the trustee rate and the top personal rate. The main issues with trusts arise, instead, in business or personal contexts such as access to residential care subsidies. For tax, three main areas of potential concern have been identified.

Trust losses

15. As with companies, trust losses are ring-fenced within the trust and cannot be distributed. Unlike companies, however, there are no restrictions on the use of trust losses by other parties.

16. We are advised that it is increasingly common for property development to occur through trading trusts. The underlying projects may be profitable, but they may generate substantial tax losses in the interim because of timing differences between the recognition of expenses and income. Inland Revenue is seeing structures which attempt to sell trust losses from one party to another.

66 The minor beneficiary rule prevents trustees from reducing the tax obligations of adult beneficiaries by diverting some of the trust's income to dependent children on lower marginal rates.

17. It will not be straightforward to resolve this issue. Trading in trust losses cannot be resolved with the type of ‘continuity of ownership’ test that applies to companies. This is because the beneficiaries of trusts do not have the same fixed entitlements as shareholders in a company.

18. In the Group’s view, such trading should generally fall foul of the general anti-avoidance provision, because it is contrary to the intent of the Income Tax Act for losses to be used by taxpayers who did not bear the economic burden of those losses.

19. In the event there are found to be deficiencies in such an approach, the Group recommends that the Government review the treatment of trust losses, potentially in tandem with a review of the loss continuity rules for companies.

Income streaming

20. Trusts can be used to ‘stream’ different types of income from a business or investment to different beneficiaries of the trust. There can be good reasons for streaming to occur. Take the example of a family trust that holds a family farm and some fixed income investments: the trust might stream the regular bond income to the surviving spouse of the settlor, while the children in the family receive income from the farm on which they work.

21. Yet streaming can also be exploited for tax purposes. For example, trusts can be used to stream taxable income to beneficiaries on low marginal tax rates, while untaxed capital gains are streamed to beneficiaries on high marginal rates. Discretionary trusts are an effective vehicle for this type of streaming because distributions can be discretionary and (unlike companies) not based on shareholdings.

22. The underlying problem, however, is not the streaming itself. Instead, it is the fact that some types of income are not taxed – the most important of which are capital gains.

23. In the Group’s view, an extension of capital income taxation would largely address the issue of income streaming. If capital gains remain untaxed, however, it may be necessary to develop specific rules to restrict abusive uses of streaming.

Income splitting

24. Trusts can also be used to ‘split’ income. Income splitting is used to lower the overall tax obligations facing a group of related people; it involves the distribution of the trust’s income to those beneficiaries within the group who earn less and therefore sit on lower marginal rates. Income splitting often involves the partner or children of a high income-earner.

25. There does not appear to be a significant problem with income splitting at the present time. There is no evidence from Inland Revenue to suggest that trusts are being used for large-scale income splitting. This probably reflects the impact of current rules, such as the minor beneficiary rule, which prevent the most abusive forms of income splitting.

Assessment

26. The trust tax rules are basically sound. Income is taxed in the hands of beneficiaries where that is possible, but is otherwise taxed at the trustee level, with alignment of the trustee rate and the top personal rate. The integrity challenges associated with trusts have reduced significantly since the 2000s, due to the alignment between the trustee rate and the top personal rate. Many of the remaining challenges associated with trusts relate to deeper issues in the tax system, such as the inconsistent taxation of capital income, and should be considered within that context.

27. The one discrete issue that may need attention relates to trading in trust losses. The Group recommends that the Government consider this issue if the general anti-avoidance rule is insufficient, potentially in tandem with a review of the loss continuity rules for companies.

Closely-held companies

28. Another major area of concern regarding structures relates to the role of closely-held companies. Again, in response to this concern, the Group has taken a close look at the tax treatment of these types of companies.

The taxation of closely-held companies

29. Closely-held companies are companies with few shareholders. Many of these companies use the general company tax rules to govern their interface with their shareholders. The other major structure is the look-through company, which flows its income and expenditure through to its shareholders.[67]

30. There are a number of challenges associated with the taxation of closely-held companies. The first set of challenges arises from the inconsistent taxation of capital income:

    - Capital gains are not generally taxed if they are earned directly by an individual, but will be taxed if they are earned in a company and distributed to shareholders as an unimputed dividend.[68] This creates a strong incentive for shareholders to find ways to access the capital gain without paying a taxable dividend.
    - An additional complication arises from the fact that capital gains are not taxed when a company is wound up. This creates an incentive for companies to wind up rather than pay out capital gains as a taxable dividend.

31. The second set of challenges arises from the misalignment between the company rate and the top personal rates:[69]

    - Taxpayers can reduce their tax obligations by earning income in a company and delaying its distribution. In principle, when the income is eventually distributed, it will be taxed at the shareholders' personal rate through the imputation system. However, when incomes are large and the period of deferral is lengthy, the reduction in taxes can be significant.
    - Since a dividend will often be subject to the top personal rate, there is an incentive for a taxpayer who is a shareholder-employee of a closely-held company to pay themselves a relatively low salary or wage to fall below the top marginal tax rate. The taxpayer may then borrow from a third party or from the company to meet their lifestyle needs, if those needs cannot be met by their salary or wages. In either case, the interest will be non-deductible to the taxpayer if used to meet their lifestyle needs. Commercially, a loan from a third party will require a market rate of interest to be paid.

      To the extent that the interest rate on a loan from a company to a shareholder is below market interest rates, the shortfall is taxed as a dividend. This gives the same result as borrowing from the third party. There is then an incentive to repay the loan. If the loan is forgiven or repaid by way of a dividend, that gives rise to taxable income.

32. Putting these challenges together, there is a range of incentives for the owners of closely-held companies to both *defer* and *avoid* the payment of tax on dividends.

Dividend avoidance

33. Dividend avoidance is an arrangement in which a company's profits or assets are paid out to shareholders without the tax that would have applied if the payment had taken the form of a dividend.

34. Many dividend avoidance arrangements take advantage of the tax exempt status of capital gains to unlock the value of existing realised capital gains and unrealised capital gains (such as goodwill) in their companies. These arrangements generally involve a sale of shares to a related party that does not result in a true disposal of the underlying property or business.

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67 Qualifying companies' are an earlier form of the look-through company. No new qualifying companies can be formed, but qualifying companies established before their income year starting on or after 1 April 2011 may retain their status.

68 The taxation of unimputed dividends reflects a deliberate policy decision to strengthen the company tax regime: any income (including capital gains) that is not taxed at the company level is taxed when distributed as a dividend.

69 The optimal response is to align the individual and company tax rate. However raising the company tax rate is outside the Group's terms of reference and the Group does not recommend a reduction in the top rate for individuals as that would make the tax system less progressive.

35. The simplest forms of dividend avoidance, known as 'dividend stripping,' are prevented by specific anti-avoidance rules. Inland Revenue has also identified a number of other arrangements, with potentially significant revenue exposure; in March 2018, it issued a *Revenue Alert (RA 18/01)* on these arrangements.

Current accounts

36. Another issue arises from the use of current accounts. Shareholders in closely-held companies can withdraw funds from the company and then use those funds for personal expenditure. This withdrawal arises through a current account which also records funds, other than capital, lent to the company by the shareholder.

37. A traditional use of a current account is for a shareholder to take drawings from the company during the year, which are then offset by shareholder salaries or dividends declared at the end of the tax year. The withdrawal is treated as a loan from the company's current account. These loans may have low-interest or no-interest terms, in which case the interest-free benefit will be taxable.

38. A current account can become increasingly overdrawn if amounts are regularly paid to a shareholder. This may occur in cases where a shareholder is using drawings from the current account to fund a higher standard of living than would otherwise be possible for them.

39. There is no obligation for a shareholder to clear their overdrawn current account at any particular time. However, current rules in effect require interest to be charged (and that interest is taxable to the company and non-deductible to the shareholder if used for personal expenses), and should in theory be sufficient. However, at times, this requires direct enforcement for Inland Revenue to ensure it occurs.

40. There may be two caveats to this.

41. Inland Revenue observes that some taxpayers have been using dividend avoidance arrangements to clear these balances and potentially create a balance that can be drawn against in the new company.

42. The amount of funds withdrawn from current accounts has increased sharply since 2010 when the trust and top rate were aligned, but misalignment continued between companies and shareholders. This would not be a problem if shareholders were complying with the rules, and loans were being repaid in full from sources other than dividend avoidance schemes. However, Inland Revenue considers that this is not always what happens in practice.

43. Secondly, some companies have run up large debts that they owe to Inland Revenue and at the same time, the company is owed large debts by the shareholders via current accounts. The reality in some of those cases is that the current accounts are never intended to be repaid. The shareholders assets are often in trusts, and the shareholder rarely, if ever, gives any security for the current account. When such companies are placed into liquidation, whether as a result of Inland Revenue action or otherwise, it is very difficult for such current account debts to be collected from the shareholders. This, in turn, leads to large write-offs of tax debts by Inland Revenue when these companies are struck off the companies register. Under current rules, this may give rise to debt remission income and the shareholder has to pay tax on such income. However, such tax is difficult to collect from the shareholder for the same reasons that the current account is difficult to collect.

Assessment

44. The challenges associated with the taxation of closely-held companies are complex and interlinked.

45. As with trusts, many of the challenges arise from the inconsistent taxation of capital income. An extension of capital income taxation – to include gains on the sale of shares – would deal with many of the problems. This may be undercut by rollover relief and that will be considered when the Group designs rules in that area.

46. While the company and personal rates remain unaligned, this will continue to raise integrity issues. The fundamentals of the current account rules are correct, although we consider the potential for a company to lend funds to shareholders that are never going to be repaid to be an issue that requires some remedial action, and we note that officials are considering this issue as part of the tax policy work programme.

47. To address the issues outlined in paragraph 43 above, the Group recommends providing the Commissioner with the ability to require a shareholder to provide security to the Commissioner if: (i) their company owes a debt to Inland Revenue; (ii) the company is owed a debt by the shareholder; and (iii) there is doubt as to the ability and/or intention of the shareholder to repay the current account.

The hidden economy

48. There are many ways to describe the hidden economy: it has been called the cash economy, the informal economy, the shadow economy, and the underground economy. The hidden economy arises because some taxpayers decide to hide some or all of their income. These actions – which can often seem innocuous to the participants – directly affect the integrity of the tax system.

Policy considerations

49. There are three major types of hidden economy activities. The first is the under-reporting of income, for example by reducing the reported value of a transaction (often known as 'skimming'). Then there are cash-in-hand transactions, which involve collusion by both the payer and the payee to ensure the payment is not officially recorded or declared at all. The final is the use of offshore technology platforms, which may provide opportunities to conceal income earned in New Zealand. Money laundering is also an essential part of the hidden economy, because it is the means to convert illegal gains into seemingly legitimate wealth.

50. Taxpayers participate in the hidden economy for many reasons. They are heavily influenced by the experience of other taxpayers and the visibility of the tax authority's enforcement activities – they are more likely to engage in non-compliance if they think there is a low risk of being caught. High compliance costs or regulatory uncertainty also tend to encourage participation in the hidden economy.

51. The opportunity to evade tax is also a feature. In some cases this means the ability to receive cash for a transaction, or to route it through an offshore technology platform or bank account in another country (where Inland Revenue may not have as much access to information).[70]

52. The other major cause of hidden economy activity stems from social mores and beliefs. Some people see aspects of the hidden economy – such as cash jobs or use of an offshore platform – as a victimless crime; others may not even realise they are doing anything wrong. Sometimes, business owners argue that they need to circumvent the tax system to keep up with their non-compliant competitors. In each case, these actions reflect a belief that no real wrong-doing is involved, or that everyone else is doing it anyway.

53. The hidden economy has a corrosive effect on the tax system. It undermines the sense of fairness that is necessary to sustain high levels of voluntary self-compliance. It also means that compliant taxpayers must pay more to make up for the lost revenue.

54. By its very nature, the hidden economy is difficult to identify and measure. Nevertheless, the loss of revenue from hidden economy activities is likely to be substantial. As one example, recent research from Victoria University has estimated that self-employed individuals under-reported an average of 20% of their gross income (Cabral and Gemmell 2018).[71] This alone may result in an annual loss of $850 million of revenue.

70 Although it should be noted that New Zealand is part of a very wide network of countries, which have tax treaties in place to facilitate the sharing of information about taxpayers to prevent tax evasion and assist in the verification of tax compliance.

71 The degree of under-reporting in New Zealand is broadly comparable to estimates for the United Kingdom and Canada; other countries, such as Greece and the United States, experience much higher rates of under-reporting (Cabral and Gemmell 2018).

55. Since 2010, Inland Revenue has received additional funding for intelligence, marketing, and tax audit activity; Budget 2018 also provided funding to enhance the withholding rules for labour income and the use of third-party reporting systems.

Assessment

56. The Group welcomes the positive impact of Inland Revenue's education and marketing campaigns, and is also pleased to see that there is now greater information sharing between Inland Revenue and other Government agencies.

57. Yet the Group believes further action is necessary. The Group strongly supports an increase in the reporting of labour income, through the use of additional withholding taxes and third party reporting systems or platforms. In some cases, this will require access to data sets held by third parties, such as digital platform providers. It will also require greater access to anti-money-laundering information. The Group's view on this is subject to measures not unreasonably increasing compliance costs on business. Any increase in withholding or reporting obligations need to fit in with existing business capabilities.

58. The Group also welcomes further efforts to prevent the use of offshore platforms to conceal income, whether those measures are increased reporting or additional withholding taxes. The Government should ensure that tax law is complied with when income and activity is in New Zealand - even if it occurs using an offshore technology platform with a country we do not exchange information with.

59. The Group notes that New Zealand is changing and so Inland Revenue must continue to tailor its products to the changing demographics to ensure that all taxpayers are aware of their obligations.

60. The Group supports the measures outlined in the recent Australian review of the hidden economy. The Government should review those measures with a view to applying them to New Zealand.

61. The Group also supports firm action to discourage undeclared cash-in-hand transactions. The Group recommends removing tax deductibility in circumstances where a payer has not followed labour income withholding or reporting rules. The Group notes the Australian Government has recently announced their intention to adopt a similar compliance measure.

Inland Revenue tax technical capability

62. The Group wholeheartedly endorses the increase in data analytics capability that will be possible following Inland Revenue's Business Transformation process, and its ability to screen and filter cases for investigations.

63. The Group also notes that the integrity issues identified in this report, and ones identified in the past, have come from the work of technically skilled investigators. No matter how good the tax policy and tax administration systems are, tax investigation is a complicated task, and so Inland Revenue must continue to invest in deep and significant technical capability across its investigation staff.

Collection

64. The Government's objectives for the revenue system spell out the importance of collection (Government of New Zealand 2018). Collecting taxes is important because it underpins public perceptions of the fairness and integrity of the tax system. All the tax rules and obligations are irrelevant if the revenue is not ultimately collected. More effective collection also has the benefit of increasing revenue without the need for any change to existing tax assessment settings.

The current approach to collection

65. Most people pay their tax through the PAYE and GST system. Such taxpayers rarely have to interact with Inland Revenue, yet are very compliant with the tax obligations. On the other hand, sole traders, companies and trusts have considerable scope to run up tax debt.

66. Inland Revenue's ability to collect tax debt is subject to four main constraints:

- Taxpayers are entitled to several safeguards under the Inland Revenue Acts, including the ability to dispute a tax assessment, and the right to request debt relief.
- The general law governing companies and trusts means that there are additional constraints on collection that don't arise with collecting from individuals.
- Inland Revenue deals with a large number of tax debtors, so it must prioritise its resources to maximise recovery and maintain public confidence in the tax system.
- Inland Revenue does not get to choose who it deals with. All New Zealanders must pay tax, so Inland Revenue must take a long-term view on building compliance across the population.

67. Inland Revenue's Compliance Model is built around a behavioural approach as to whether a taxpayer is 'disorganised,' 'can't pay,' or simply 'won't pay.' The Compliance Model places a strong emphasis on understanding the taxpayer's perspective of the tax system and proactively influencing behaviour before non-compliance occurs. This also continues after the tax debt is incurred.

68. One of the significant challenges in the collection of tax is that the inherent collectability of a tax debt differs depending on what type of entity is the taxpayer – is it a person, a company, a trust, etc. The pursuit of a tax debt against a person can result in that person's bankruptcy. The pursuit of a tax debt against a company can result in a liquidation order against the company, but the individuals behind the company are unaffected, free to start another company that might repeat the cycle of non-payment of tax.

Policy considerations

69. While Inland Revenue's overall approach follows best practice, the Group has identified a number of challenges and opportunities for improving fairness in collection between different vehicles used.

Company debt and the corporate veil

70. In particular, the Group has identified a major gap in the current collections model: the use of company structures to incur significant tax debt to Inland Revenue, without any real hope or expectation of repayment. These issues do not arise when debt is incurred by an individual, because of the risk of bankruptcy.

71. This gap arises as a result of two important concepts in company law:

- The corporate veil – which treats the company as a separate legal person from its shareholders.
- Limited liability – which means the financial liability of a shareholder for their company's debts is limited to the capital commitment of their shares.

72. The corporate veil and limited liability protection support entrepreneurial risk-taking, because they allow shareholders to operate a business without risking their personal assets. At the same time, though, they allow delinquent directors and shareholders to incur significant PAYE debt and other tax arrears, secure in the knowledge that the debt will stay ring-fenced in the company, with little risk to their personal assets.

73. Other OECD jurisdictions take a more balanced approach to these issues. Australia, Canada, and the United Kingdom all have the power of direct recourse against directors who default on their employee tax deductions. In Australia, for example, directors are personally liable for arrears on employee deduction payments under the *Director Penalty Notice* regime.

74. There are important trade-offs associated with the introduction of a similar regime in New Zealand. A stringent liability regime may discourage entrepreneurship and deter people from seeking directorships. Yet, in the Group's view, there will be significant integrity and revenue benefits from lowering the corporate veil in certain circumstances. However, a warning system must be in place before this occurs as is the case in Australia. This is to protect directors from exposure to liabilities from defaults that they could not reasonably be expected to be aware of.

Departure prohibition orders

75. The Group has also discussed the merits of the Australian *Departure Prohibition Order*, which can prohibit a taxpayer from leaving Australia until their tax liability is resolved.

76. Inland Revenue can already apply to the courts for arrest warrants (which have the effect of preventing taxpayers from leaving New Zealand), but there may be a role for departure prohibition orders in cases that are not sufficiently serious to justify a warrant.

Criminal penalties

77. During the course of its discussion, the Group has noted that the threshold for proving knowledge-based PAYE and GST offences differ:

- For PAYE, culpability arises when an employer makes a PAYE deduction and is aware that the funds should have been paid to Inland Revenue, but instead applies the funds to another purpose (such as paying other creditors).
- For GST, it is not sufficient to demonstrate that the funds were collected and not paid by the business; Inland Revenue must go further and demonstrate that the taxpayer had the intention to evade the tax.

78. Given that both PAYE and GST are meant to be collected and promptly paid over by a business, there appears to be no good reason for the different standards of proof required.

Collection agency

79. At the moment, all agencies (including Inland Revenue and the Ministry of Social Development) are responsible for collecting unpaid debts arising from their specific legislation. This means each agency must maintain specialist debt collection capacity, which is entirely different to the general skill sets required to carry out the agency's core responsibilities. Also, while these agencies will at times be interacting with the same individual, they all have different powers to collect, and different abilities to write off debt.

80. The Group has received a submission proposing the creation of a single centralised Crown debt collection agency. The submitter argued that a centralised agency would realise greater economies of scale and achieve more equitable outcomes across all Crown debtors. A single agency would support the review and standardisation of the Crown's approach to debt collection, as well as enhance the specialisation and professionalism of the staff engaged in this work. The Group agrees with these arguments and recommends the creation of a single centralised Crown debt collection agency.

Assessment

81. The Group supports Inland Revenue's general approach to collection, but believes more can be done to increase collection and encourage compliance.

82. In particular, the Group recommends that the Government explore measures to allow for company PAYE and GST debts to be imposed on directors personally through a *Director Penalty Notice* regime. The Group also recommends the establishment of a single centralised Crown debt collections agency.

83. Other options for improving compliance include an alignment of standards of proof for PAYE and GST offences, and the use of departure prohibition orders. The Group seeks to advance these proposals for the final report.

Summary

The Group recommends:

15.1 A review of loss-trading, potentially in tandem with a review of the loss continuity rules for companies.

15.2 That Inland Revenue have the ability to require a shareholder to provide security to Inland Revenue if: (i) the company owes a debt to Inland Revenue; (ii) the company is owed a debt by the shareholder; and (iii) there is doubt as to the ability/and or the intention of the shareholder to repay the debt.

15.3 Further action in relation to the hidden economy, including:

- an increase in the reporting of labour income (subject to not unreasonably increasing compliance costs on business);
- a review of the measures recently adopted by Australia in relation to the hidden economy, with a view to applying them in New Zealand; and
- the removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.

15.4 That Inland Revenue continue to invest in the technical and investigatory skills of its staff.

15.5 Further measures to improve collection and encourage compliance, including:

- making directors personally liable for arrears on GST and PAYE obligations (as long as there is an appropriate warning system);
- departure prohibition orders;
- an alignment of the standard of proof for PAYE and GST offences.

15.6 The establishment of a single centralised Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.

16

Charities

1. Charities and not-for-profits make important contributions to the wellbeing of New Zealand. The not-for-profit sector supports efforts to bolster our social, human, and natural capital, and is a direct expression of manaakitanga, kaitiakitanga, and whanaungatanga. The economic activities of charities and not-for-profits – as the recipients of donations and the owners of business enterprises – also affect the accumulation of physical and financial capital in the New Zealand economy.
2. In Te Ao Māori, koha (giving) is an expression of manaakitanga which is practiced in conjunction with utu (reciprocity). Utu sets a code of conduct which ensures that the behaviour of participants is fair, respectful, and transparent. Ensuring the fairness of the charitable sector gives effect to manaakitanga, and encourages communities to continue to look after each other.
3. The Government supports the work of charities through various means. The primary means of support for charities in the tax system is an exemption on passive income and business income.[72] Charities and certain not-for-profit organisations can also be treated as 'donee organisations,' which allows taxpayers to receive tax benefits for monetary donations to those organisations.[73] Charitable organisations also benefit from a fringe benefit tax exemption and concessional treatment under the GST Act.
4. The effect of the tax treatment is that no tax revenue is received by Government in respect of donations to charities[74] or the activities carried on by the charity. In this respect, the charitable sector essentially replaces Government decision-making and policy on how best to bolster our social, human and natural capital.
5. The Group believes that how the charitable sector is using what would otherwise be tax revenue available to Government should be subject to review from time to time in order to verify that the social outcomes are being achieved. The Group supports the inclusion of the tax treatment of the charitable sector on Inland Revenue's work programme, as announced in May 2018.
6. Contributions to the charitable sector have increased over time. According to Statistics New Zealand, the number of not-for-profits rose from 97,000 in 2004 to 114,110 in 2013. Donations, non-government grants and membership fees to not-for-profits rose 40 percent, from $1.9 billion in 2004 to $2.7 billion in 2013. In 2013 the sector contributed 4.4% to GDP.[75]

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72 Not-for-profit entities that fail to meet the requirements for the exemption are taxable on their income, but can access a concessionary income tax deduction of up to $1000.

73 An individual who donates to a donee organisation receive a donation tax credit of 33⅓% of the value of the donation, while a company or a Māori authority will receive a tax deduction.

74 This is either through the donations tax credit for individuals or a deduction for companies and Māori Authorities.

75 The source of this information is the "Non-profit institutions satellite account, 2013", published by Statistics New Zealand in June 2016. Statistics New Zealand plans to publish the next release in March 2020 (for the 2018 financial year).

7. The not-for-profit sector includes 27,000 charities registered with the Department of Internal Affairs (DIA) under the Charities Act 2005. For the 2016-17 income year, DIA's register shows that charities earned gross income of $18 billion and managed total assets of $59 billion.

8. Inland Revenue data shows that an increasing amount of business income is moving from the tax base into the tax exempt charity sector; significant taxable businesses are owned and operated by charitable operators. DIA Charities Services data shows that the number of charities with income from goods and services activities has not substantially grown over recent years however the size of the charities currently undertaking these activities appear to be growing. Additionally, DIA has observed an increase in start-up businesses registering as charities and seeking wider donations to support their business activity.

9. While many charities are standalone organisations, a number of entities – such as corporates, local authorities, and Māori authorities – have charities as part of their group structures (to varying degrees).

10. The not-for-profit sector includes many small entities – such as clubs and societies – that are not eligible to be registered charities under the Charities Act, as they do not operate for the public benefit, or choose not to register because the costs of registration outweigh the benefits. Additionally, tax concessions for the purposes of fringe benefit tax and GST are not based on whether the relevant entity is a registered charity. The entities accessing those concessions are a larger category than registered charities.

11. The Group acknowledges that the Government has launched a review of the Charities Act 2005, in order to ensure that the Act remains effective and fit-for-purpose. Following the conclusion of that review, the Group suggests that the Government consider whether the issues identified in this chapter have been fully addressed, or whether further action on tax matters is required.

Business income

12. Income derived from the business activity of a charity, and of entities owned by charities, is exempt from income tax. Charities may use businesses for a variety of reasons; to maximise returns to further charitable purposes or, provide goods and services at less than commercial margins to meet identified community needs. The Group has received many submissions arguing that this treatment confers an unfair advantage on the trading operations of charities.

13. The most recent review of the Australian tax system – the Henry Review – considered this issue and concluded that income tax concessions for not-for-profit organisations should be retained. Then Henry Review argued that the tax concessions do not confer a competitive advantage because:

   - A trading operation owned by a charity has a profit maximising objective in order to grow the funds used to support the charitable purpose. This means the trading operation faces the same incentives as a commercial entity when it comes to setting its prices and its tax-exempt status will not lead to it undercutting its rivals.
   - As a charity can earn tax-free income from an alternative passive investment (for example, a bank deposit), the tax concession for trading income would not distort the charity's behaviour compared with a taxpaying entity.

(Henry 2009)

14. The principle of competitive neutrality provides a rationale for taxing each taxpayer's active and passive income at the same rate. This, in turn, suggests a case to provide a charitable exemption for business income if the passive income of a charity is exempt. On the other hand, a charitable business that does not distribute its income will be able to accumulate capital faster than an equivalent taxpaying business.

Accumulation and distribution

15. This suggests the underlying issue is more about the extent to which charitable entities are distributing or applying surpluses from their activities (active or passive) for the benefit of the charitable purpose qualifying them for the tax exemption. If a charitable business is regularly distributing funds to its head charity, or providing services connected with its charitable purposes, it will not accumulate capital any faster than a taxpaying business.

16. The Group takes the view that the accumulated assets and income of all charitable business and charitable organisations should be used for charitable purposes in order to qualify for the tax exemption.[76]

17. However, the Group is aware that some charities may have good reasons to accumulate funds (for example, to save for the acquisition or construction of capital assets, to prepare for large crises in the future, or to take an intergenerational view towards the management of assets), so changes to the current exemption should only be made if these charities could be adequately protected.

18. The Government's review of the Charities Act 2005 includes consideration of the obligations of registered charities. This aspect of the review could shed further light on the issues of accumulation and distribution. The Group would be comfortable, as a matter of process, for the Government to consider the tax aspects of the treatment of charities after this legislative review has concluded.

Private foundations

19. Under current New Zealand law, individuals may establish private charitable foundations and charitable trusts, and receive the same donation tax credit and gift deductions as if they had donated to an arm's-length donee organisation. The size of these donor tax concessions has increased significantly since caps on the donation tax credit were lifted in 2009. In many cases, these tax-preferred donations form the capital base of the foundation, which then receives a charitable tax exemption on income earned from the capital.

20. These private foundations and charitable trusts are not required to have arm's-length governance boards. This means the donor and their associates may decide the focus and distribution policy of the foundation or charitable trust. These foundations and charitable trusts may also invest into businesses controlled by the settlors or by associates of the settlors – sometimes on non-market terms.

20. There may also be minimal use of foundation or charitable trust funds for charitable purposes, with no particular distributions policy and no rationale for accumulation except a desire for the fund to be self-sustaining in the future, or for foundation and charitable trust distributions to occur years after donation tax relief has been obtained.

21. New Zealand's approach to these organisations is unusual. Private foundations are subject to specific rules in other jurisdictions. In Australia, for example, 'private ancillary funds' play a key role in private philanthropy. They offer tax deductions for donations and benefit from income tax exemptions. Yet they are also subject to certain requirements: for example, they must make a minimum annual distribution of 5 percent of assets to charitable organisations, and they must invest prudently in accordance with a written investment policy.

22. The Government should consider whether New Zealand should apply a similar distinction between privately-controlled foundations and other charitable organisations.

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76 This could be by way of a proportionate distribution requirement (for example a 'safe harbour' distribution) of a proportion of annual income akin to a public company return to shareholders. Another option is to tax the income of charities in the first instance, but tax paid would be able to be refunded if the income met certain requirements of having been applied or distributed.

Deregistration

23. Special tax rules apply to charities that are deregistered under the Charities Act 2005. The rules require the assets of a deregistered charity to be disposed or transferred within twelve months. If there is no disposal or transfer, the deregistered charity will be subject to income tax on the value of its net assets at its normal income tax rate.

24. The purpose of the rules is to protect the integrity of the revenue base. If an entity has claimed charitable tax exemptions and accumulated assets, these assets should always be destined for a charitable purpose, even if the entity is deregistered.

25. The income tax due date is typically at least 24 months after the date the charity is deregistered. This means there could be a considerable time value of money benefit between when income tax would have been due (if the entity were not a charity), and when it is finally paid as a tax on deregistration. This may not be an issue if the amounts involved are minor; nevertheless, the Group does want to ensure that the benefits of this delay are not used inappropriately by some entities.

25. New Zealand's approach to deregistration is similar to other jurisdictions, but less robust. Canada, for example, keeps charitable assets in the sector by applying a tax equal to the *entire* net value of the assets of a revoked charity, which they can only reduce by transferring their assets to an eligible donee.

26. The Government should consider whether the New Zealand deregistration tax rules could be amended to more effectively keep assets in the sector, or ensure that there is no deferral benefit through the use – and then deregistration – of charitable structures.

Charities and GST

27. Under the GST Act, non-profit bodies can access a tax concession which allows input tax deductions for all GST incurred other than in making exempt supplies. Other businesses, in contrast, need to establish the extent to which goods and services are applied in making taxable supplies for input tax to be deductible.

28. The concession allows non-profit bodies to claim far more input tax deductions, which will often exceed output tax payable. This concession can make it easier for non-profit bodies than for other entities to achieve the desired rate of return needed for investment.

29. New Zealand's approach is distinctive. Jurisdictions with comparable VAT or GST systems have more restrictive tests that apply to the deduction of input tax, with the effect that some not-for-profit bodies are treated as final consumers and bear the cost of GST on their activities. Including only non-profit body commercial activities in the GST base could be more consistent with GST's broad base framework as it would still tax private (or end-user) consumption.

30. The Group recommends that the Government review whether it is appropriate to treat some not-for-profit organisations as if they were final consumers, or, alternatively, whether it is appropriate to limit the GST concessions to a smaller group of non-profit bodies, such as registered charities.

Summary

The Group:

16.1 Believes the Government should periodically review the charitable sector's use of what would otherwise be tax revenue, to verify that intended social outcomes are being achieved.

16.2 Supports the Government's inclusion of a review of the tax treatment of the charitable sector on its tax policy work programme, as announced in May 2018.

16.3 Notes the income tax exemption for charitable entities' trading operations was perceived by some submitters to provide an unfair advantage over commercial entities' trading operations.

16.4 Notes, however, the underlying issue is the extent to which charitable entities are accumulating surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities.

16.5 Recommends the Government consider whether to apply a distinction between privately-controlled foundations and other charitable organisations.

16.6 Recommends the Government consider whether to amend the deregistration tax rules to more effectively keep assets in the sector, or to ensure there is no deferral benefit through the application of these rules.

16.7 Recommends the Government review whether it is appropriate to treat some not-for-profit organisations as if they were final consumers, or, alternatively, to limit GST concessions to a smaller group of non-profit bodies such as registered charities.

16.8 Recommends the Government consider whether the issues identified in this chapter have been fully addressed or whether further action is required, following the conclusion of the review of the Charities Act 2005.

17

The administration of the tax system

1. Tax policy is given effect, day in and day out, through the administration of the tax system. The quality of administration is central to public perceptions of the legitimacy and fairness of tax policy; the effectiveness of administration will determine the Government's ability to achieve its policy intent in levying taxation.

2. At its heart, the tax system relies on an implicit social contract between citizens and the Government, because the Government's ability to tax ultimately depends on the consent and acceptance of its citizens. A well-administered system will raise revenue fairly and efficiently and provide a predictable outcome for taxpayers – but a poorly-administered system will undermine the public trust that sustains prevailing levels of taxation, as well as the spirit of voluntary self-compliance by taxpayers that underpins efficient tax collection.

3. The long-term sustainability of tax policy settings also depends on public understanding and acceptance of the major policy settings. The government thus has a kaitiaki (stewardship) role in ensuring there is broad buy-in to the legitimacy of the tax system. Inland Revenue has built strong relationships with tax practitioners, but wider groups of stakeholders also need to see their views reflected in the design and administration of tax policy, or the consensus underpinning the system will begin to fray.

4. Tax administration must be consistent with the principle of manaakitanga (care for others). This means the system should welcome all groups into the design and administration of tax policy; it also means the system should be simple to use and easy to navigate, especially for those who find it difficult to engage with Government agencies and processes.

5. There are many facets of tax administration that could potentially be explored. In this chapter, however, the Group will focus on four key issues that affect public perceptions of the tax system: the approach to tax secrecy; the resolution of tax disputes; the process for the development of tax policy; and the way in which participants in the system perceive the purpose of the legislation.

Tax secrecy and tax transparency

6. Tax secrecy is a topical issue at the moment. Internationally, the lack of transparency around the tax affairs of some wealthy individuals and some multinational companies may be undermining public confidence in the fairness and integrity of tax systems around the globe.

7. New Zealand, like other countries, must find the right balance between protecting the privacy of individual taxpayers and protecting personal and commercially sensitive information held by Inland Revenue and providing sufficient information about the way the system operates, without compromising Inland Revenue's ability to perform its functions, so that taxpayers can have confidence in its fairness and impartiality.

Policy considerations

8. There are good reasons for some degree of confidentiality in the tax system. Confidentiality rules act as a balance to Inland Revenue's broad information gathering powers and encourage taxpayers to provide information with the assurance that their information will be used and protected appropriately; they protect information that is commercially sensitive, and information about sensitive personal relationships.

9. New Zealand's current tax secrecy rules, however, are very broad. The Tax Administration Act 1994 requires Inland Revenue to maintain the secrecy of all matters relating to the Inland Revenue Acts. Information cannot be disclosed except for the purposes of 'carrying into effect' the Inland Revenue Acts, or if disclosure is necessary for the purpose of performing a duty of Inland Revenue. The broad scope of the secrecy rule means that much information cannot be released – even if release will not breach the confidentiality of individual taxpayers, and even if there will be public benefit from access to the information.

10. Other countries take a very different approach to tax secrecy and tax transparency. In Sweden, for example, tax decisions are normally public (Nergelius 2017). Similarly, tax return information is publically available for most individuals and entities in Norway (Devos and Zackrisson 2015). Closer to home, Australia has also taken a number of measures to increase tax transparency, including the development of a voluntary tax transparency code for medium and large businesses.

11. Public submitters have suggested that New Zealand should emulate the approaches taken in other countries, and adopt greater transparency in the tax system. Some submitters argued that tax transparency could be used as a means to reduce tax avoidance by multinational companies, while others were more focused on the potential to use statistical information from Inland Revenue for research purposes.

12. The Government recently introduced a Bill to narrow the scope of the current tax secrecy rules in the Tax Administration Act 1994.[77] The Bill will focus the secrecy rules on the protection of information that relates to individual taxpayers and that could identify them (or is otherwise private or commercially sensitive). This approach is more closely aligned with the approach taken in jurisdictions such as Australia and Canada.

13. The lack of good statistical information has hampered empirical research about the New Zealand tax system. One major benefit of the Government's Bill is that it will become far simpler for Inland Revenue to release statistical information, which in turn will enrich research and debate about the tax system.

14. The Group considers that:

    - Inland Revenue should have the ability to publish aggregated data and information that does not reveal information about individuals nor information about individual corporates that would not otherwise be publicly available (for example, in annual financial reports).

    - Inland Revenue should be encouraged to publish or make available a broader range of statistics, in consultation with potential users, either directly or (preferably) through Statistics New Zealand.

    - As our economy shifts onto a more environmentally sustainable base, the Group has discussed whether the tax system can help collect data to inform and support this transition. At a minimum, Inland Revenue should collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.

77 The Taxation (Annual Rates for 2018–19, Modernising Tax Administration, and Remedial Matters) Bill was introduced into Parliament in June 2018.

15. Underlying these recommendations is a broader point: Inland Revenue should review whether the information and data that it currently collects offer the most useful insights, or whether other sets of information and data would better inform policy development and research, respond to public interest, and build public understanding about the tax system. The Group will take a further look at the information and data collected by Inland Revenue in the Final Report.

Assessment

16. The Group strongly encourages the Government to release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available).

Tax disputes

17. Even in the most well-designed tax system, disputes will inevitably arise between some taxpayers and the tax administration. In order to maintain public confidence in the administration of the tax system, it is crucial that these disputes are handled in a way that is perceived by all stakeholders to be fair and impartial.

18. The Group is aware that some stakeholders are concerned about current dispute resolution processes in the tax system. The Group has heard that the resolution of even simple cases can require substantial efforts in terms of time, effort, and cost. This, in turn, creates a risk that some taxpayers with legitimate cases are 'burnt off' by the process because they cannot afford the time or money necessary to continue proceedings.

19. The Group also acknowledges that the effect of many of its recommendations will be to increase the powers held by the Commissioner of Inland Revenue. As an appropriate check and balance, the Group has therefore considered whether to bolster the rights of taxpayers in the process of dispute resolution.

The role of the Ombudsman

20. Taxpayers already have the right to complain to the Ombudsman if they have not resolved a dispute through Inland Revenue's complaints management service.

21. As a means of strengthening the Ombudsman's role, the Group has discussed a proposal to establish a Deputy Ombudsman position with sole responsibility for complaints involving Inland Revenue. The new Deputy Ombudsman position would supplement the existing tax expertise in the Office of the Ombudsman.

22. The Group is not convinced that a new Deputy Ombudsman position is necessary. However, the Group believes the Office of the Ombudsman should have sufficient knowledge of the tax system to deal with complaints that Inland Revenue has been unable to resolve, and notes there is existing capacity and knowledge within the Office to handle complaints about Inland Revenue. The Office should also deal with complaints arising from the operation of the new Crown debt collection agency that the Group is proposing, and may need additional support in the event of an unsustainable increase in the volume of complaints relating to that.

23. The Group is of the view that the scope for accessing the Ombudsman should be similar to that for Judicial Review. Outside of that scope, the individual agency should be seeking to resolve the complaint.

24. The Group suggests that any further expansion of the resources available to the Ombudsman should include consideration of provision for additional tax expertise within the Office, and possibly support to manage any increase in the volume of complaints relating to the new combined debt agency proposed by the Group.

Taxpayer advocate service

25. The Group has also considered a proposal to establish a taxpayer advocate service that would assist certain taxpayers – such as low income earners, small businesses, and individuals with English as a second language – in disputes with Inland Revenue. The advocate could play multiple roles, including the provision of advice, and facilitation and mediation services.

26. The Group believes that a taxpayer advocate service could play a valuable role in the fair resolution of tax disputes. The service would need to be functionally independent from Inland Revenue in order to serve as a credible advocate for the taxpayer in dispute, but it might be able to draw on back-office support from Inland Revenue. The Group suggests that the structure of Departmental Agency would be most appropriate. It would be contained within Inland Revenue and report directly to the Minister of Revenue, rather than the Commissioner of Inland Revenue.

27. The Group recommends that the Government establish a taxpayer advocate service to assist with the resolution of tax disputes. The Group is also currently considering the merits of a truncated dispute resolution process for small disputes.

The development of tax policy

28. Since 1994, tax policy has been developed using the *Generic Tax Policy Process*. The Generic Tax Policy Process sets out a number of phases for tax policy development, with the aim of ensuring there is early consideration of key policy elements and trade-offs, as well as opportunities for substantial external input into policy formulation.

29. The five phases of tax policy development are as follows:

    - The *strategic* phase involves the development of the Government's economic strategy, fiscal strategy and three-year revenue strategy. Broad policy proposals may be publicised through channels such as Budget documentation.
    - The *tactical* phase involves the development of a three-year work programme and annual resource plan to implement the revenue strategy. This process allows for the initial scoping and development of policy options, and may involve public consultation.
    - The *operational* phase consists of detailed policy design, with public consultation on the design details. This phase culminates in Ministerial and/or Cabinet approval of tax policy initiatives.
    - The *legislative* phase involves the translation of policy decisions into legislation. External consultation takes place through public submissions to the select committee considering the bill.
    - The *implementation and review* phase includes the post-implementation review of new legislation and the identification of any remedial issues.

Assessment

30. The Group received a number of submissions setting out concerns with how the Generic Tax Policy Process is currently operating. The Group acknowledges those concerns. Inland Revenue is currently exploring options to improve the Generic Tax Policy Process. The Group supports these efforts, in particular to ensure that a wider range of voices is heard in the policy development process.

31. In the course of developing refinements to the Generic Tax Policy Process, the Group recommends that the following principles should be applied to public engagement:

    - Good faith engagement by all participants.
    - Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Crown/Māori Relations).
    - Earlier and more frequent engagement.
    - The use of a greater variety of engagement methods.
    - Greater transparency and accountability on the part of the Government.

32. The Group notes that it is essential for the Treasury to play a strong role in the development of tax policy. The Group welcomes the recent strengthening of the Treasury's tax capability, and recommends that the Treasury maintains high levels of resourcing in the area.

33. The Group also wishes to stress the importance of maintaining deep, senior tax technical expertise within Inland Revenue's policy function. There is nothing to indicate that tax policy in the future will become less complex or technically demanding, so it is vital that Inland Revenue continues to invest in its technical policy capability. At the same time, it is vital to complement this technical capability with strategic policy expertise.

Legislative frameworks

34. The primary task of the Group has been to focus on tax policy, rather than on the legislation through which tax policy is given effect. Nevertheless, the Group has discussed the use of purpose clauses in tax legislation to give clearer statements of the purpose of the legislation.

Policy considerations

35. There are currently three main Acts relating to taxation: the Goods and Services Tax Act 1985, the Tax Administration Act 1994, and the Income Tax Act 2007.

36. The Tax Administration Act 1994 and the Income Tax Act 2007 have short and rather technical purpose clauses that do not explain Parliament's overriding intent in levying taxation; the Goods and Services Tax Act 1985 has no purpose clause at all. Purpose clauses are now used if appropriate when new taxing regimes are introduced, however these are regime specific.

37. An overriding purpose clause would spell out the ultimate reason for levying taxation – to raise the revenue that is necessary to support the Government in its endeavours to enhance the wellbeing of New Zealanders.

38. The Tax Administration Act 1994 is the only Act that encompasses all tax legislation.

39. An overriding purpose clause to be introduced in the Tax Administration Act 1994 could explain that the legislation specifies:
    - The rules for effective and efficient administration and collection of tax revenues, so the Government can improve the wellbeing of New Zealanders.
    - The rights and obligations of taxpayers.
    - The rights and obligations of the Commissioner of Inland Revenue.

40. Another possible addition could be a reference, for each of these, to the parliamentary intent of the legislation. The suggested change could buttress the Parliamentary Contemplation test in the general anti-avoidance rule, and focus taxpayers and the courts on the original intent of the legislation, in addition to the specific language of the legislation.

Assessment

41. The Group encourages the continuing use of purpose clauses where appropriate and recommends the inclusion of an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.

Summary

The Group:

17.1 The Group strongly encourages the Government to release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available).The Government could consider further measures to increase transparency as public attitudes change over time.

17.2 Encourages Inland Revenue to publish or make available a broader range of statistics, in consultation with potential users, either directly or (preferably) through Statistics New Zealand.

17.3 Encourages Inland Revenue to collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.

17.4 Recommends that any further expansion of the resources available to the Ombudsman include consideration of provision for additional tax expertise within the Office, and possibly support to manage any increase in the volume of complaints relating to the new Crown debt collection agency proposed by the Group.

17.5 Recommends the establishment of a taxpayer advocate service to assist with the resolution of tax disputes.

17.6 Recommends the use of the following principles in public engagement on tax policy:

- Good faith engagement by all participants.
- Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Crown/Māori Relations).
- Earlier and more frequent engagement.
- The use of a greater variety of engagement methods.
- Greater transparency and accountability on the part of the Government.

17.7 Notes the need for the Treasury to play a strong role in tax policy development, and the importance of Inland Revenue maintaining deep technical expertise and strategic policy capability.

17.8 Encourages the continuing use of purpose clauses where appropriate and recommends the inclusion of an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.

Part IV

Summary

18

Summary of recommendations

The Group has discussed many issues over the past six months. Yet there is also much to do before the presentation of the Final Report in February 2019.

Already, however, the Group has identified a range of opportunities to improve the fairness, balance, and structure of the tax system.

This chapter summarises the decisions and recommendations emerging from the Group's work to date. It also notes area where further analysis is contemplated.

The Group's views on these issues are by no means final, and feedback is welcome. Together, we can shape the future of tax.

Capital & Wealth

6.1 The Group is still forming its views on the best approach towards extending the taxation of capital income. Only once such an extension is designed can a meaningful comparison take place between different options and the status quo. Appendix B sets out the Group's initial thinking on further design features of broad-based taxation of capital income. The Group will work toward its ultimate recommendations in the Final Report.

Retirement Savings

The Group recommends that the Government:

7.1 Remove ESCT on the employer's matching contribution of 3% of salary to KiwiSaver for members earning up to $48,000 per year.

7.2 Reduce the lower PIE rates for KiwiSaver funds by five percentage points each.

7.3 Consider ways to simplify the determination of the PIE rates (which would apply to KiwiSaver).

The Group will give further consideration to the taxation of savings in the Final Report, in light of its broader conclusions on the tax system.

Housing Affordability

8.1 The Group's work on housing affordability is closely linked with its work on the taxation of capital income. The Group will have particular regard to housing market impacts as it finalises its recommendations regarding capital income.

Environmental & Ecological Outcomes

9.1 There is significant scope for the tax instruments to play a greater role in delivering positive environmental and ecological outcomes in New Zealand. Environmental tax instruments can be a powerful tool for ensuring people and companies better understand and account for the impact of their actions on the ecosystems on which they depend.

9.2 Taxes are not well suited to all environmental problems and regulation will still be a better approach for dealing with some issues. The Group has prepared a draft framework identifies a range of criteria and design principles for environmental taxes to be effective. Environmental taxation and regulation should be considered together for positive outcomes.

9.3 In the short term, there may be benefits in expanding the coverage of the Waste Disposal Levy, and for reassessing waste and landfill disposal externalities to see if higher rates are warranted. There could also be benefits from strengthening the ETS and advancing congestion charging. Over the medium term, there could be benefits from greater use of tax instruments to address challenges in both water pollution and water abstraction. Addressing

Māori rights and interests in fresh water should be central to any changes. In the longer term, new tools could allow for an expanded role for environmental taxes to address other challenges such as biodiversity loss and impacts on ecosystem services.

Corrective Taxes

The Group:

10.1 Recommends that the Government review the rate structure of alcohol excise with the intention of rationalising and simplifying it.

10.2 Recommends that the Government prioritise other measures to help people stop smoking before considering further large increases in the tobacco excise rate.

10.3 Recommends that the Government develop a clearer articulation of its goals with regard to sugar consumption and gambling activity.

International Income Tax

The Group:

11.1 Supports New Zealand's continued participation in OECD discussions on the future of the international tax framework.

11.2 Recommends that the Government be ready to implement an equalisation tax if a critical mass of other countries (including Australia) move in that direction.

11.3 Recommends that the Government ensure, to the extent possible, that our double tax agreements and trade agreements do not restrict our taxation options in these matters.

GST

The Group:

12.1 Recognises the significant public concern regarding GST, but does not recommend a reduction in the rate of GST. This is because lowering the GST rate would not be as effective at targeting low- and middle-income families as either:

- Welfare transfers (for low income households); or
- Personal income tax changes (for low and middle income earners).

12.2 Does not recommend the removal of GST from certain products, such as food and drink, on the basis that the GST exceptions are complex, poorly targeted for achieving distributional goals, and generate large compliance costs.

12.3 Believes there is a strong in-principle case to apply GST to financial services, but there are significant impediments to a workable system. The Government should monitor international developments in this area.

12.4 Does not recommend the application of GST to explicit fees charged for financial services.

12.5 Recognises that there is active international debate on financial transaction taxes, which should be monitored, but does not recommend the introduction of a financial transactions tax at this point.

The Group has already reported to Ministers on the issue of GST on low-value imported goods, and the Government is advancing that work.

Personal Income & The Future of Work

The Group:

13.1 Will provide recommendations regarding the rates and thresholds of income tax in the Final Report in February 2019.

13.2 Supports Inland Revenue's efforts to increase the compliance of the self-employed, particularly an expansion of the use of withholding tax as far as practicable, including to platform providers such as ride sharing companies.

13.3 Supports the facilitation of technology platforms to assist the self-employed meet their tax obligations through the use of smart accounts or other technology based solutions.

13.4 Recommends that Inland Revenue continues to use data analytics and matching information to specific taxpayers to identify underreporting of income.

13.5 Recommends that there be a review of the current GST requirements for contractors who are akin to employees.

13.6 Recommends that the Government seek to align the definition of employee and dependent contractor for tax and employment purposes.

13.7 Recommends additional Government support for childcare costs, but believes this support is best provided outside the tax system.

The Taxation of Business

The Group recommends that the Government:

14.1 Retain the imputation system.

14.2 Not reduce the company tax rate at the present time.

14.3 Not introduce a progressive company tax.

14.4 Not introduce an alternative basis of taxation for smaller businesses, such as cashflow or turnover taxes.

14.5 Consider other measures to reduce compliance costs. Depending on the fiscal position, these measures could include:

- Increasing the $2,500 threshold for paying provisional tax to $5,000-$10,000.
- Increasing the $10,000 year-end closing stock adjustment to $20,000-$30,000.
- Increasing the $10,000 limit for the automatic deduction for legal fees, and potentially expanding the automatic deduction to other types of expenditure.

14.6 Not change the thresholds around fixed assets.

14.7 Retain the 17.5% rate for Māori authorities.

14.8 Extend the 17.5% rate to the subsidiaries of Māori authorities.

14.9 Consider technical refinements to the Māori authority rules, as suggested by submitters, in the Tax Policy Work Programme.

The Integrity of the Tax System

The Group recommends:

15.1 A review of loss-trading, potentially in tandem with a review of the loss continuity rules for companies.

15.2 That Inland Revenue have the ability to require a shareholder to provide security to Inland Revenue if: (i) the company owes a debt to Inland Revenue; (ii) the company is owed a debt by the shareholder; and (iii) there is doubt as to the ability/and or the intention of the shareholder to repay the debt.

15.3 Further action in relation to the hidden economy, including:

- An increase in the reporting of labour income (subject to not unreasonably increasing compliance costs on business).
- A review of the measures recently adopted by Australia in relation to the hidden economy, with a view to applying them in New Zealand.
- The removal of tax deductibility if a taxpayer has not followed labour income withholding or reporting rules.

15.4 That Inland Revenue continue to invest in the technical and investigatory skills of its staff.

15.5 Further measures to improve collection and encourage compliance, including:

- Making directors personally liable for arrears on employee GST and PAYE obligations (as long as there is an appropriate warning system).
- Departure prohibition orders.
- An alignment of the standard of proof for PAYE and GST offences.

15.6 The establishment of a single centralised Crown debt collection agency to achieve economies of scale and more equitable outcomes across all Crown debtors.

Charities

The Group:

16.1 Believes the Government should periodically review the charitable sector's use of what would otherwise be tax revenue, to verify that intended social outcomes are being achieved.

16.2 Supports the Government's inclusion of a review of the tax treatment of the charitable sector on its tax policy work programme, as announced in May 2018.

16.3 Notes the income tax exemption for charitable entities' trading operations was perceived by some submitters to provide an unfair advantage over commercial entities' trading operations.

16.4 Notes, however, the underlying issue is the extent to which charitable entities are accumulating surpluses rather than distributing or applying those surpluses for the benefit of their charitable activities.

16.5 Recommends the Government consider whether to apply a distinction between privately-controlled foundations and other charitable organisations.

16.6 Recommends the Government consider whether to amend the deregistration tax rules to more effectively keep assets in the sector, or to ensure there is no deferral benefit through the application of these rules.

16.7 Recommends the Government review whether it is appropriate to treat some not-for-profit organisations as if they were final consumers, or, alternatively, to limit GST concessions to a smaller group of non-profit bodies such as registered charities.

16.8 Recommends the Government consider whether the issues identified in Chapter 16 have been fully addressed or whether further action is required, following the conclusion of the review of the Charities Act 2005.

The Administration of the Tax System

The Group:

17.1 Strongly encourages the Government to release more statistical and aggregated information about the tax system (so long as it does not reveal data about specific individuals or corporates that is not otherwise publicly available).The Government could consider further measures to increase transparency as public attitudes change over time.

17.2 Encourages Inland Revenue to publish or make available a broader range of statistics, in consultation with potential users, either directly or (preferably) through Statistics New Zealand.

17.3 Encourages Inland Revenue to collect information on income and expenditure associated with environmental outcomes that are part of the tax calculation.

17.4 Recommends that any further expansion of the resources available to the Ombudsman include consideration of provision for additional tax expertise within the Office, and possibly support to manage any increase in the volume of complaints relating to the new Crown debt collection agency proposed by the Group.

17.5 Recommends the establishment of a taxpayer advocate service to assist with the resolution of tax disputes.

17.6 Recommends the use of the following principles in public engagement on tax policy:

- Good faith engagement by all participants.
- Engagement with a wider range of stakeholders, particularly including greater engagement with Māori (guided by the Government's emerging engagement model for Crown/Māori Relations).
- Earlier and more frequent engagement.
- The use of a greater variety of engagement methods.
- Greater transparency and accountability on the part of the Government.

17.7 Notes the need for the Treasury to play a strong role in tax policy development, and the importance of Inland Revenue maintaining deep technical expertise and strategic policy capability.

17.8 Encourages the continuing use of purpose clauses where appropriate and recommends the inclusion of an overriding purpose clause in the Tax Administration Act 1994 to specify Parliament's purpose in levying taxation.

Appendices

Appendix A: Methodology for calculating revenue forecasts

Extending the taxation of capital income

Assumption: Growth rate

1. Residential investment property prices are assumed to appreciate at a 3% nominal annual rate (2% inflation plus 1% real growth rate) similar to what is projected in the 2018 Budget Economic and Fiscal Update.[78] That rate is also used for other categories of real property.

2. New Zealand listed share prices are assumed to appreciate at 3% per year.[79]

Assumption: Size of base

3. The table below shows how initial values (from 1 April 2021) were derived from the most recently available data. From the most recent data available, prices are assumed to increase at a rate of 3% per year until 1 April 2021. In addition, the base for residential investment property and commercial and industrial property are assumed to increase by an additional 2.8% to reflect additional building investment.

Assumption: Turnover rate

4. The costing incorporates a realisation basis. For real property categories, average holding periods are taken from Core Logic data as of the first quarter 2018. These are:
   - Residential investment property – 6.40 years;
   - Commercial and industrial property – 7.12 years;
   - Agricultural property – 6.90 years.

5. New Zealand shares are assumed to have an average holding period of two years.

Base	Data Source	Observation Date	Value at Observation Date ($Billion)	Grossed-Up Value at 1 April 2021 ($Billion)
Residential rental property	Reserve Bank Household Balance Sheet	December 2017	269	324
Commercial, industrial and other property	Corelogic	October 2017	217	261
Rural	Corelogic	October 2017	181	199
New Zealand listed shares	Reserve Bank Household Balance Sheet and Managed Fund Assets	March 2018	131	143

78 BEFU 2018 projects house prices to increase by 3.4% in 2021 and 3.7% in 2022.

79 NZX capital index information shows New Zealand shares appreciated at an average annualised rate of 3.9% over January 1990 to December 2017.

Risks: Risks that the forecast revenue could be understated

6. **Unknown parts of the base** – The forecast base uses elements of the base that are known through published statistics – values of real property and New Zealand shares. Some elements of the base are not known and so are not costed. These include – residential property that is not owner-occupied housing or residential investment property (e.g. second homes), shares in Australian listed companies, and shares in private companies and intangible property such as goodwill, brands, trademarks and intellectual property.

Risks: Risks that the forecast revenue could be overstated

7. **Overlap with current revenue account property** – Some property is already subject to tax on gain when sold (revenue account property). The most significant of these are real property sold by developers and dealers. This is not adjusted for due to lack of information. This also includes property subject to the brightline rule and taxable under the intention test.
8. **Tax motivated behavioural change** – It is possible that taxpayers could change their behaviour to improve tax outcomes from a realisation based tax, such as accelerating realisation of losses and deferring realisation of gains. This is not incorporated due to lack of information to make an accurate assumption.

Risks that could either overstate or understate the forecast

9. **Variation from assumptions** – actual conditions may vary from what is assumed. In particular, the actual appreciation rate is likely to vary over time and be both above and below the assumed growth rate at times. Other factors, such as size of the base and turnover rates, could also vary from the assumptions.
10. The revenue forecast was calculated using a Treasury model that has been reviewed by NZIER.

Appendix B: Design Features for extending the taxation of capital gains

I Introduction

1. In its terms of reference, the Group was asked to consider whether a system of taxing capital gains, excluding the family home or land under it, and excluding any inheritance tax, would improve the tax system. The Group's high-level views on extending the taxation of capital income generally are contained in Chapter 6. This Appendix is intended to describe possible design features that might be necessary to tax capital gains that are not already taxed. These design features are needed in order to decide whether extending the taxation of capital gains in the manner set out is desirable, or whether another option, including the status quo, is preferable.

2. The Government has requested the Group report on changes that would make the tax system more fair, balanced and efficient. The Government's objective is to have a tax system that:

    - is fair, efficient, and simple and where tax is collected;
    - promotes the long term sustainability and productivity of the economy;
    - supports a sustainable revenue base to fund government operating expenditure around its historical level of 30% of GDP;
    - treats all income and assets in a fair, balanced and efficient manner;
    - is progressive; and
    - is simple and coherent.

3. Whether these objectives can be met in relation to the proposals set out below is obviously dependent on the design features. Accordingly, the Group has not yet reached a view on whether introducing the changes required will meet the Government's objectives. This Appendix is not a final report as it contains the Group's preliminary conclusions or sets out the issues the Group thinks need to be considered further in reaching a decision. Many of the issues are complex and will require industry and stakeholder consultation.

4. The Group intends to consider many of the issues in this Appendix further and to make recommendations in its Report in February.

II What income should be included

General

5. Many other countries have had comprehensive capital gains tax regimes for over 50 years. New Zealand already taxes capital gains from certain asset classes because it has introduced specific taxing rules, on an as needed basis, over this period (for example, the financial arrangements rules tax capital gains from debt instruments). Accordingly, the Group has identified a list of asset classes that are not already subject to tax. Capital gains from these assets would be included in the tax base and would be subject to the rules proposed below. Such assets would be:

    - interests in land (other than the family home); this includes all other residential land, commercial, agricultural, industrial and leasehold interests not currently taxed;

- intangible property, including goodwill; the Group is still considering how widely this should be defined;
- all other assets held by a business or for income producing purposes that are not already taxed on sale (for example, depreciable assets);
- shares in companies and other equity interests; and
- certain choses in action (for example trade tie agreements).

We refer to the assets whose gains would be brought into the tax base as “included assets”.

6. Using a defined list of included assets is intended to avoid any difficulties that might arise if the extension applied simply to ‘capital gains from all assets not otherwise taxed.’ The latter approach has been adopted in some other countries and has caused difficulties when unintended gains or losses have been brought into the tax base. Gains or losses from assets not included in the initial list of included assets can be brought into the base separately and intentionally if desirable.
7. Bringing these included assets into the tax base is in effect an extension of the definition of ‘revenue account property’ – that is, property where the proceeds of sale are subject to income tax. The cost of that property is deducted at the time of sale, with the result that the net gain is taxable.
8. Although we propose a list of included assets, our approach is deliberately comprehensive in its coverage of gains from capital, rather than limited. This is consistent with the design principles. The list is not deliberately intended to exclude any assets, other than the family home and some personal assets. These exclusions are discussed below.

Family home exclusion

9. The terms of reference require that any proposed taxation of capital gains does not apply to the family home or the land under it. We have referred to this as an ‘excluded home.’ Under present tax rules gains from sales of family homes are not generally taxed unless the owner has a regular pattern of buying and selling family homes.

Principles for defining the family home

10. How the excluded home is defined is important as it potentially affects all homeowners.[80] The Income Tax Act (the Act) already contains two definitions of a family home however the Group considers that these will need to be modified. The proposed principles to determine an excluded home could include the following:
    - The home has been occupied mainly as a residence by the person and their family as their home which is their ‘centre of vital interests’; this is intended to be a ‘use’ test and not a purpose or intention test.
    - It should not be sufficient that the person has used the house as a family home for most of the time they owned it, if it is not so used over the 12 months before sale, unless that non-use relates to a period where the home is held for sale (considered below).
    - If a person owns more than one home then only one home can be an excluded home. Which home is excluded would be determined by considering the location of the person’s centre of vital interests. This test is used under New Zealand’s double tax agreements and it can be modified appropriately. It would consider where a person’s family lived, how frequently the person returned to the home, the reasons for being in one home and not the other etc. The circumstances of the arrangements must be examined as a whole, but the personal acts of the individual receive special attention in this assessment.
    - It is possible that two people who are married, in a civil union or a de facto relationship, and who are genuinely living apart, can each have a family home, although this will be uncommon.

80 One for purposes of the brightline (section CB 16A), the other for purposes of the other land taxing provisions (section CB 16).

- A person who is not tax resident in New Zealand would not benefit from the excluded home concession; this would also mean that a person who might be tax resident in New Zealand but is treated as being resident in another country under a double tax agreement will not be able to meet the excluded home tests and will be taxable on the sale of their New Zealand home.
- Generally, a personal residence will not be an excluded home unless it is the family home of an owner of the residence. However, provision needs to be made for the ownership of family homes by trusts and companies.
- The family home exclusion could apply to a home owned by a trust that will, in substance, belong to a beneficiary who occupies the house as a family home. For instance, if a parent settles the home they occupy on a discretionary family trust, the home should be able to be an excluded home while the parent is living in it. However, suppose the parent settles a different home onto a trust and one of their family members lives in the home (an adult child). Two examples illustrate how the rules might work under different factual assumptions. Under the first example, assume there is no intention on the part of the parent to make an irrevocable gift on the child. The parent is a trustee of the trust. In that case the second house should not be an excluded home. In substance the home is still owned and controlled by the parent, who is not living in it as they are living in another home. Under this example, the exemption would apply to a home owned by a trustee only if a beneficiary is both living in the house and becomes irrevocably entitled to the proceeds of any sale of the house, or to the house itself. Under the second example, the parent could make a gift to the family member who would themselves settle a family trust and live in the house. In this case the home would qualify for the excluded home exemption.
- A home owned by a flat owning company can be an excluded home of the person who holds the relevant shares; the shares would benefit from the exemption, since the right of ownership and occupation is transferred by way of a transfer of the shares not the home.
- The excluded home exemption could apply to a home owned by an ordinary company (including a “look through company”), if the company shares are all owned by a person or persons who occupy the home as a family home. This should be the case even if the home is rented to the occupiers by the company.
- A family home could continue to retain its status as an excluded home for up to 4 years in certain circumstances where the taxpayers were not actually living in it. These might include expatriates working overseas before returning to New Zealand, parents moving cities within New Zealand for work reasons, or moving within a city for schooling.
- Where a person also uses their home for other purposes, e.g. as a homestay, the exemption could be reduced accordingly. An apportionment could be made based on floor area. Requiring an apportionment in this way might discourage property owners from making a portion of their home available for rental accommodation. An alternative to requiring apportionment based on use or space, might be to allow the excluded home status to still apply if the residence was “mainly used” as a residence by the taxpayer, or to consider a *de minimis* rule.
- The exemption would apply to the land on which the house sits, up to the greater of 4,500 m^2, or the amount required for the reasonable occupation and enjoyment of the house (this is based on the existing family home exclusion in the land taxing provisions. It is not the exclusion used in the bright line test, which allows a larger area of land used in lifestyle blocks to be exempt from those rules).

Change of use – moving in and out of the base

11. Change of use rules will also need to be developed for circumstances where the owner of an excluded home moves out of the home, or the owner of a rental property or second home moves into the property so that it becomes an excluded home. In these cases, there would be a deemed sale for market value, as follows:

    - Where the residence becomes an excluded home, this will trigger a deemed sale for market value, giving rise to a taxable gain or loss.

    - Where the residence ceases to be an excluded home there will be no taxable gain event, but the sale will establish a cost price for calculating the gain or loss on a later sale.

12. The value of the home at the transition point would be market value at that time. Use of ratings values would reduce tax planning opportunities however they might not reflect the true value in many circumstances.

13. An alternative for dealing with change of use situations could be to apportion any gain on sale of the house over the time when it is rented and the time when it is occupied as a family home. This approach has been adopted by other countries.

Very expensive homes

14. Excluding gains realised on the family home encourages people to invest more capital in their family home, where it can generate untaxed income (both in the form of the benefit of living in the home, and in the form of the gain on sale). This is sometimes referred to as the “mansion effect” where people move to larger and larger homes and devote considerable resources to improving their homes, maximising resale values.

15. There may be merit in limiting the excluded home exemption in some way for higher value homes. For example, to the extent the amount invested exceeds, say, $5 million, the gain on sale could be taxable. So, in the case of a house which, together with capital improvements, cost the owner $7.5 million, one third of the gain on sale would be subject to tax. For the vast majority of people, imposing tax at this level would have no impact on the taxation of the sale of their family home.

16. However, where the threshold level might be set would inevitably be somewhat arbitrary and could motivate unusual behaviour such as buying property for just under the threshold and selling other assets for more than their market value. The Group notes our terms of reference indicating that the family home and the land under it is not to be subject to the proposed rules extending the taxation of capital gains and that taxing some part of higher value family homes would be contrary to those terms.

Personal use assets

Personal property

17. Cars, boats and other household durables generally decline in value and when they are sold the loss represents the cost of having private non-taxed consumption benefits. It is not proposed to include these assets in the rules.

18. Higher value jewellery, fine art and other collectibles (rare coins, vintage cars etc.) might be able to be distinguished on the basis that they are purchased as investments and are expected to appreciate in value. It is not proposed to include these assets in the rules. Excluding them from the new rules may incentivise investment in such assets as opposed to more productive assets and there might also be an argument to tax them, over certain thresholds. Nevertheless, the Group proposes to exclude these assets for reasons of simplicity and compliance cost reduction. The Group acknowledges that such a concession could be revisited in the future. Existing tax rules can tax certain gains on sale, if the assets were acquired for resale; these rules will continue to apply to such assets.

Real property

19. The inclusion of residential land as a taxable asset (other than the excluded home, discussed above) means that owners of holiday homes, baches, cribs and other second homes will be taxable on gains accruing after the effective date of the introduction of the tax.

20. The inclusion of these private assets raises an issue regarding deductibility of costs relating to land held for private purposes. Because the land is used for private purposes, not all costs relating to it should be deductible. It is proposed that costs of a revenue nature, such as rates, interest (including foreign exchange losses on foreign currency borrowing), insurance and repairs and maintenance, should not be deductible, either when incurred or when the property is sold. It is proposed that costs of a capital nature (improvements) incurred after purchase should be added to the cost base of the asset and deductible from the proceeds of sale. Existing case law and rules can assist in determining what is on revenue account and what is on capital account.

Foreign real property

21. For New Zealand residents, homes located outside New Zealand would be taxable. However, there is an argument for exempting homes owned outside New Zealand if it was likely that no New Zealand tax on the foreign home would be collected. This could be the case if the other country also taxed any capital gain on the property. If that same gain was taxable in New Zealand, a credit for that foreign tax would be allowed against the New Zealand tax payable. Any New Zealand tax on sale would accordingly be relatively small, such that the compliance costs might not be justified.

22. An alternative to a full exclusion for foreign homes would be to apply a 'grey list' where only homes subject to tax in countries imposing similar capital gains taxes (and not receiving any main home exemption) would be excluded from the rules. In any event, any arguments for exclusion need to be balanced against perceptions of fairness if some overseas homes are out of the base. The Group is still considering this.

III When to tax: accrual versus realisation

23. The Group proposes that tax should be imposed on realisation rather than accrual in most cases. However, the Group proposes retaining the current fair dividend rate (FDR) regime that applies to shares in foreign companies (other than certain Australian listed shares). This is levied on five percent of the annual opening values of the shares.

24. Realisation is the basis on which both trading stock and revenue account assets (such as timber and land which is subject to tax) are generally taxed. Current rules therefore provide a useful set of default rules for determining when gains from assets which are proposed to be brought into the base should be taxed.

Actual realisation

25. At its core, realisation involves the sale of an asset for market value. The purpose of imposing tax on realisation rather than accrual is that it ensures the tax is imposed at a time when the person subject to the tax has the funds to pay it, and when the amount of the gain has been finally determined. However, it is well established that there is a realisation even when the consideration for a sale is in kind rather than cash, and when payment of the consideration is deferred, for a shorter or longer period. This can perhaps be explained on the basis that the seller has a choice as to whether to sell, and if it is concerned about its ability to pay the tax, can either require some immediate cash component or not sell at all. The Group proposes that this core concept also applies to included assets.

26. Current law also provides for assets to be treated as realised where they are destroyed or scrapped. In these cases, the event will generally give rise to a loss, except where there are insurance proceeds or other compensation which exceed the asset's cost. In these cases, tax is imposed, though some exceptions have been made in the context of losses in the course of natural disasters.

Deemed realisation

27. The Group is also considering whether a person who incurs significant expenditure remediating damage to property might be treated as having partially disposed of that property, so that the person could claim a deduction for the cost of the remediation at the time it is incurred, rather than having to wait for a deduction on sale or by way of depreciation. Examples would be buildings with high seismic strengthening costs or weathertightness issues. Such costs would be included in the cost base for calculating any taxable gain or deductible loss. In many cases the magnitude of the costs is likely to lead to an overall deductible loss if the building is sold. It may be seen as problematic to require such buildings to be sold merely to access that loss.

28. Current law also provides for deemed realisation of revenue account assets (i.e. for imposition of tax on accrued gains or losses) in several situations where there is no cash or other consideration at all, nor any third-party valuation. Most significantly, these are:

    - when an asset leaves the tax base in certain situations. An example is when a New Zealand resident migrates to another country holding an appreciated financial arrangement which is not subject to tax when sold by a non-resident owner. In this case tax is imposed to ensure that the gain that has accrued while the financial arrangement is in the New Zealand base is taxed;
    - when assets are transferred for no consideration, for example:
        - on death;
        - on gift, including a settlement on a trust;
        - on distribution by a trust or a company to a beneficiary or a shareholder;
        - in a settlement of relationship property.

29. In some of these cases, particularly transfer on death and settlements of relationship property, there are provisions which allow the tax on any gain accrued up to the date of transfer to be deferred, so that it does not arise until the transferee realises the asset. For example, roll-over relief applies to most property left to a spouse, and to standing timber left to a close relative. This means there is no tax at the time of death, but when the spouse or relative sells the property, the taxable gain will include the gain that accrued while the deceased owned the property, as well as while the spouse or relative owned it.

30. In relation to the first situation (asset leaving the base), the Group considers that whenever an asset that is in the tax base leaves it, tax should be imposed on the owner's accrued gain up to that point. Gifts to a charity or other donee organisation are an exception, discussed below.

31. In relation to the second situation (transfers for no consideration), the existing law suggests that roll-over relief is appropriate in some cases but not all. However, the existing provisions appear to be somewhat ad hoc, and have not been drafted in the context of a generally applicable capital gains tax. Because of the importance of this subject, roll-over relief is considered in some detail in the following section of this Appendix.

32. The Group notes that under the terms of reference, whatever treatment of assets held on death is adopted, the family home and the land under it is to be an excluded asset. Whether the home is sold by the executor/administrator or left to the owner's children, relatives or some other beneficiary, the increase in value up to the time of the person's death (and to the time of sale or distribution by the executor/administrator) should be permanently exempt. It will be possible for the house to then become an excluded home of the person inheriting it if the recipient also resides in the house. Consideration is being given to providing a time period in which the house can be held in trust or rented, pending sale or other disposal in the process of administering estate assets.

IV When to tax: roll-over relief

What roll-over relief is

33. Roll-over relief is the mechanism that allows a realisation-based tax to accommodate deferral of taxation on transactions or events that are realisations. Realisations would otherwise trigger a requirement to calculate taxable gain or loss. There are a number of situations that may justify roll-over relief, and these are considered in more detail below.

34. Roll-over relief does not mean that the gain or loss is never taxed. It means that taxation of the gain or loss is deferred until there is a later realisation event which is not itself subject to roll-over relief. For example, suppose A buys a holiday home for $500,000. When A dies, she leaves the holiday home, worth $700,000, to her children. The children sell it five years later for $950,000.

35. If the transfer of the holiday home to A's children is treated as a realisation event not eligible for roll-over relief:

   - A will have $200,000 of taxable income at the time of her death, which will be returned by her executor/administrator.
   - A's children will have taxable income of $250,000 when they sell the holiday home.

36. If the transfer is eligible for roll over relief:

   - A will be treated as having no taxable income from the holiday home on her death;
   - A's children will have taxable income of $450,000, at the time of sale.

37. Roll-over relief is considered appropriate where there has been a technical legal change in ownership – in principle giving rise to a realisation of taxable gain – but for fairness and/or efficiency reasons it is not considered that this technical change in legal ownership justifies taxing the gain at that time.

38. Conversely, extensive roll-over relief creates adverse equity and lock-in effects. For example, if an asset is owned by a person for a lengthy period, then left to an heir who similarly owns it for a lengthy period, the tax payable on sale by the heir can be a significant portion of the asset's value. This may make it very difficult for the heir to justify a sale of the asset (since it will diminish their wealth by the amount of the tax). Roll-over relief in such cases may defer the tax, potentially indefinitely, undermining the fairness objectives of taxing this form of income. Despite these drawbacks, most countries that tax capital gains across a broad base still allow roll-over relief in various circumstances.

Principles of rollover relief

39. The Group believes it is important to establish principles or tests for when roll-over should apply. Without such principles, ad hoc roll-overs will be adopted, reflecting political responses to lobbying, rather than sensible tax policy.

40. The Group is still developing these principles but our current thinking is that roll-over relief should be provided where there has been a legal change in ownership of the asset giving rise to a technical realisation of the gain or loss but this change in legal ownership is not in reality a realisation of the gain or loss as most people would understand it. This seems to arise in two cases:

   - There has been no change in ownership in substance. The clearest example of this is a transfer of relationship property where the change in legal ownership merely reflects the fact that recipient partner always had an ownership interest in the property. This can then be extended further to transfers to any close relation, applying a wider concept of family ownership. However, the concept of close relation tends to be cultural and changing over time. For Māori it may extend to whānau in a wide sense, hapu or iwi. Under tikanga concepts property can be often seen as being held for others, including future generations, and these interests should be accommodated by the tax rules. On death it can be reasonably argued that any bequest is by its nature provided because of a close relationship with the recipient. These comments refer to relationships between individuals. Similar concepts apply to transfer of property between entities owned by the same individuals or between the individual and the entities. That is, here is also no change in ownership in substance where assets are legally transferred from a person to an entity owned by that person – such as a company – or between different entities owned by the same person.

- There has been a legal change in ownership (and a change in substance) but the nature of the transaction is such that it has not given rise to a gain that can be said to have "come home" to the vendor. The clearest example of this is where land is compulsorily acquired for public works and the landowner has used the proceeds to acquire other land as a replacement. Current law (in some respects) and common sense would not treat this as a realisation event giving rise to a taxable gain because the landowner is, in reality, in no different position to a person who continued to own land. This can be contrasted with a market value sale to an unrelated party, crystallising certain gains available to the vendor to use at their discretion (including on consumption); a clear gain has "come home".

41. How narrow or broadly these principles are applied is a matter the Group is still considering. A broad application of the second principle could allow roll-over relief to farmers selling a small farm and buying a larger one, a person selling one business in return for another business. It would also recognise the seemingly reasonable argument of iwi organisations that they should be able to sell less desirable settlement assets to buy more desirable assets without a tax impost from doing so. On the other hand, allowing multiple circumstances for roll-over relief whenever a gain is realised but reinvested would defer taxation of gains for many years - negating some of the revenue and other benefits of taxing these gains, and potentially giving rise to horizontal inequities.

42. The Group is therefore considering how far roll-over relief should be extended and whether any broader application of such relief should be restricted to illiquid assets – assets not easily realised within an ongoing business or social operation.

43. To illustrate these points we describe below how roll-over relief might apply to:

    - gifts on death
    - inter vivos gifts
    - settlements on trusts and distributions by trusts
    - involuntary dispositions of assets where the proceeds are reinvested
    - dispositions of business assets where proceeds are reinvested
    - dispositions of business assets where there is no change in economic ownership.

Roll-over on death

44. Taxing gains accrued up to the time of death has significant advantages over not doing so. If gains are not taxed on death, a person is encouraged to retain all their assets instead of giving them away or selling them. For example, they might raise mortgages on their assets to avoid the tax otherwise payable on the sale of the asset, at a time when additional debt might not make economic sense. Accordingly, taxing gains on death reduces the incentive to retain assets during a person's life time. Taxing gains accrued to the date of death also ensures that capital gains cannot be deferred for longer than a person's life time. This has benefits in terms of the equity and revenue raising objectives of the tax. By re-setting the cost base of the assets, it also reduces lock-in effects for future transactions, which reduces the economic inefficiency of a realisation-based tax.

    The Group believes that the arguments for roll-over relief on death are stronger in the following situations:

    - Where property is left to a spouse, civil law or de facto partner. In this case the basis for the relief is that the deceased and the surviving partner are in substance a single economic unit in terms of their ownership and enjoyment of their assets and the income from those assets. However, this relief would not apply if the partner is not New Zealand resident, so that the effect of the transfer is that the property leaves the tax base. This limited relief recognises the property interests the recipient might have already had in the deceased's estate (under relationship property laws for example). However applying a wider family unit concept of ownership could extend the relief to other all family members or indeed anyone whose relationship with the deceased is such that they are the recipient of a bequest.

- Where the property is illiquid. In this case the imposition of the tax might require the property to be sold to fund the tax liability. In such cases, the asset may not be ready for sale and as such the owner may lose value in a "forced sale". Illiquid assets would include shares in family companies and unincorporated businesses, including farms. It might also include shares in other unlisted companies. It would not include listed shares which can be easily traded. It probably would not include land which is rented, or land held outside the context of a business, unless the legal nature of the land means it is very difficult to sell or use as security for a loan (Māori land, for example). Land valuations are common and relatively reliable. The market for most land is more liquid than for most businesses, and it is more easily able to be borrowed against. The arguments in favour of this roll-over apply regardless of the identity of the transferee under the will of the testator. Generally, the transferee will be a relative. But limiting the relief to relatives would create undesirable boundary and definitional issues. Again, the relief would not apply if the beneficiary is not New Zealand resident.

45. There is also an argument that death should not be treated as a realisation event at all, or should be entitled to complete roll-over relief (which is the same thing), on the basis that:

- it does not involve the receipt of any consideration by the deceased. It therefore fails the core definition of a realisation event, and there is no other good basis for treating it as a realisation;
- there is in most cases no change in the economic ownership of the assets if the assets are treated as owned not just by the deceased but also by their wider family, to whom in most cases the assets are left.

46. One way to allow more limited deferral would be to provide that roll-over could not apply to consecutive transactions. For instance, if a rental property acquired by a testator on market were left to the testator's only daughter, roll-over might apply to that transfer. However, if the daughter then left the same rental property in her will, roll-over relief would not be available a second time. However, this kind of limitation might be complex to draft and difficult to monitor.

47. The Group also considered the treatment of appreciated assets left to charities and other donee organisations. Currently there is no tax on a testamentary gift of an appreciated revenue account asset to a charity. But a testamentary gift to a charity or donee organisation also does not give rise to a charitable or other public benefit donation credit. This is both because it is not in cash and because there is an exclusion for testamentary gifts from the credit. There does not seem to be any reason to change this treatment for included assets.

48. The Group has not considered the tax treatment of changes in value occurring while an asset is held by an executor/administrator. Current law may provide guidance for this. As a general proposition the Group comments that there may be merit in treating such changes in value for some reasonable period after death in the same way as changes in value arising before death.

49. If roll-over relief on death was given on a reasonably narrow basis, it would:

- apply to all transfers to a surviving spouse or other partner;
- apply to transfers of illiquid assets, such as private businesses (including farms) or companies; and
- not apply to transfers of liquid assets (such as bank accounts and listed shares) or to transfers to family trusts for the reasons outlined below.

50. A broader basis is to allow roll-over relief for all testamentary dispositions (again, the family home is an excluded asset and is not taxed at all), regardless of the asset type or who the recipient is. As mentioned, this has the effect of increasing lock-in and deferring the revenue collected from the tax but it means that assets do not need to be sold on death to fund the tax.

Roll-over relief for gifts during lifetime (inter vivos gifts)

51. The rules applying to roll-over relief on death are important because whatever treatment is adopted for transfers on death could also apply to gifts made by a person during their lifetime. Any distinction between the two could lead to unnecessarily complex structuring and outcomes which are the result of tax planning rather than being desirable in themselves. For example, if property is eligible for a roll over if transferred on death but not inter vivos, the owner will be incentivised to retain it until death. However, from a commercial and/or personal perspective, it might be desirable for ownership to be transferred at an earlier point. Taxpayers may well take steps to achieve that outcome in substance while avoiding a change in legal ownership, and this may trigger undesirable uncertainty and disputes.

52. In relation to gifts of appreciated assets to donee organisations, such gifts are currently not eligible for a charitable donation tax credit as they are not monetary. Consistent with this approach, there should be no tax imposed on any appreciation at the time of gift. Either:

    - the gift should be treated as a realisation event, in which case there would be both taxable gain or loss and a charitable donation credit for the value of the gift; or
    - the gift should be treated as having no tax consequences, either in terms of taxing gain or loss, or a charitable donation credit.

53. Again, this treatment is consistent with the suggested approach to bequests to such organisations mentioned above at paragraph 46.

Roll-over relief for settlements on trusts

54. The same principle should apply to determine when settlements of assets on trusts are subject to tax. A settlement of assets on a trust is in essence a gift, albeit that except in the case of a fixed trust the extent to which any particular donee will benefit from the gift may not be determined at the time the gift is made. Again, a transfer of an excluded home to a trust will not be treated as giving rise to tax in any event, since the family home is not included in the proposed rules.

55. To the extent that roll-over relief depends on the identity of the transferee, settlement on a trust raises an obvious problem. Generally, the trust will have more than one beneficiary, and often their interest in the trust assets will be either discretionary or difficult to determine (as in the case of a life tenant). The narrower basis above in relation to transfers on death would give transferee-based roll-over relief only to transfers to spouses and civil law or de facto partners. Accordingly, any transfer to a trust which does not have such a person as the sole possible beneficiary would probably not be entitled to roll-over relief.

56. Under the broader basis above, where roll-over relief applied to all testamentary transfers (that is, to any beneficiary under a will or on intestacy, whether they were an individual or a trust) then all settlements on trust would be eligible for roll-over relief. Again, the treatment on death needs to be consistent with the treatment before death to avoid convoluted asset planning.

Roll-over relief for in-kind distributions by trusts

57. Assets settled on a trust may subsequently be distributed to one or more of the beneficiaries. Under current law, such a distribution is treated as a realisation of those assets by the trustee for market value, with no provision for roll-over relief. The beneficiary is treated as having received a trust distribution equal to the market value of the asset distributed.

58. In analysing the effect of the proposed reform to these kinds of transactions, it is helpful to keep quite separate the position of:

- the trustee, who is transferring an asset which is potentially subject to tax;
- the beneficiary, who should be taxed on the distribution in the same way as the beneficiary would be taxed if the distribution were in cash rather than in kind.

One way to keep this distinction clear is to consider the position if the asset were first sold to the beneficiary for market value, and the proceeds then distributed to the beneficiary in cash, the cash being used to pay the purchase price of the asset.

59. If there is a narrow approach to roll-over on death and gifts, then rules would be required to prevent trusts being used to circumvent such restrictions. The treatment of a distribution by a trust could conceivably depend upon the nature of the trust. If the distribution to the beneficiary is one that is required by the terms of the trust deed (e.g. if the property is held for named beneficiaries in equal shares, to be distributed on the happening of a specified event) then roll-over relief might be provided on the basis that the distribution gives effect to an already identified beneficial ownership.

60. In other cases, the current treatment of distributions of revenue account assets (i.e. treated as disposed of for market value) might be more appropriate. However:

- Concerns about the effect of imposing tax on a transfer where there is no consideration to pay the tax may still support roll-over relief, as in the case of a transfer of illiquid assets on death.
- If roll-over relief is provided for transfers of certain assets on death, gifts, and contributions to a trust, and if those assets are taxed when distributed by a trust, the amount of tax involved may be considerable. This calls into question whether a different tax treatment for distributions from trusts can be justified.
- Taxing distributions from trusts differently from transfers on death would create a distinction between property held on trust and property held outright. For example, it would be preferable from a tax perspective to leave appreciated property to a person outright rather to leave it to them as a trustee. The former course would allow the property to be passed on free of tax (on death) rather than taxable (on winding up of the trust).

Is there a need for deemed realisation events for trust assets?

61. Assets that are not eligible for roll-over relief on death can be transferred to a trust as a way of avoiding tax on gain on the transferor's death, for assets not entitled to roll-over relief (under the narrow approach – note that the rules outlined below would not seem necessary if the broader roll-over relief were available on death and gifting). Although the inter vivos transfer to the trust will trigger recognition of gain or loss up to the time of the settlement, if the assets are held by the trust when the transferor/settlor dies, the additional gain or loss that would have arisen because of death can be avoided. Given that trusts are likely to soon have a 125 year perpetuity period, it is also possible that a trust can be used as a device to avoid two or three "tax on death" realisation events (again, under a narrow approach).

62. It is possible to have a rule that deems a family trust to have disposed of its assets for their market value when certain events occur or time periods pass. For example, assets could be deemed sold for their market value when the settlor who contributed the assets dies — this option would be most consistent with the rationale behind denying rollover relief on death, unless the settlor truly had no control over the trust.

63. Alternatively, excessive deferral through trusts could be avoided if a family trust were deemed to sell its assets on a more periodic basis, e.g. every 20 years (possibly with some roll-over relief if appropriate). The Group understands Canada has a provision of this kind.

Involuntary dispositions of business assets

64. Roll-over relief needs to be considered where a business "disposes" of an asset involuntarily and reinvests the proceeds in a replacement asset. Examples are where:

    - land is taken under the Public Works Act 1981;
    - an asset is destroyed by a natural disaster. In this case there will be a gain if any insurance proceeds or other compensation exceed the asset's cost price.

65. The Group considers that these transactions should be treated as dispositions, but that where the proceeds are reinvested in a replacement asset, roll-over relief should be provided. There may be a requirement that the replacement asset is of a similar nature to the one disposed of. Where this requirement is not met, that means the taxpayer has taken the opportunity effectively to step away from ownership of the type of asset disposed of, either to invest in another type of asset, or to fund consumption. In that case, the argument for deferring tax on any appreciation the person has enjoyed is weaker.

66. The Group recognizes that this proposal:

    - may encourage people to make reinvestment decisions they would not make otherwise, because there will be a tax preference to reinvest in an asset the same or similar to the one lost;
    - may also encourage people not to accept offers for appreciated property which are not compulsory, in order to be made an offer which is compulsory and therefore attracts roll-over relief. On the other hand, offers for depreciated property would be accepted before compulsory acquisition, in order to allow a deduction to be claimed.

Disposition of business assets where proceeds reinvested

67. This in turn raises the issue of whether roll-over relief should be extended to voluntary dispositions where proceeds are reinvested in a replacement asset. An example of such relief is section 1031 of the US Internal Revenue Code, which allows roll over where proceeds of sale of a non-trading stock business asset is reinvested within 180 days of sale in another such asset which must be identified within 45 days of sale. The seller must also not have received the sale proceeds. Since 2017, section 1031 applies only to real estate assets.

68. New Zealand provided roll-over relief of this kind in respect of depreciation recapture on personal property business assets until 1988.

69. This form of roll-over relief is intended to eliminate the lock-in effect for businesses which for whatever reason need to replace one asset with another. For example, the business may be growing and needs to sell smaller premises to obtain large ones. Or it may need to change its location or upgrade its productive capacity. It could apply to a farmer seeking to sell a farm in one location and acquire a larger farm in a different area. Imposing tax on the sale will reduce the amount available for reinvestment and therefore discourage transactions which are otherwise economically efficient. This is an inevitable consequence of a realisation based tax, as opposed to an accruals-based one.

70. Potentially this form of relief could apply when business premises are sold and replaced with other business premises.

71. Providing roll-over relief for such transactions can have the following disadvantages:

    - It can result in lock-in and long term tax deferral, which reduces the equity benefits of the tax and the revenue generated. Potentially, the tax can be deferred until the owner, or their heirs, decides to use the proceeds of sale for consumption rather than investment.

- It discourages taxpayers from investing in assets which do not qualify for the relief, where that would be more efficient than investing in assets which do.
- It is likely to give rise to persistent efforts to expand the relief.
- It requires both complex legislation and enforcement and is likely to give rise to disputes from time to time.
- It is likely to require loss ring-fencing on all kinds of assets for which such reinvestment is possible. Without ringfencing, taxpayers selling assets of the kind to which like-kind exchange roll-over is available would:
  - in relation to depreciated assets, ensure that they do not qualify for roll-over relief, and thus be able to deduct the loss against other income;
  - in relation to appreciated assets, ensure that they do qualify for roll over relief if at all possible.

72. On the other hand, extensive roll-over may be seen as more in accord with a realisation based approach to taxing asset gains. The Group is still considering the extent to which roll-over relief should be provided.

73. Consideration will also need to be given in this context to the rules taxing livestock, and in particular how the extension of the taxation of income from capital would apply to livestock taxed under the herd scheme.

Corporate re-organisations

74. Roll-over relief would also be considered for corporate reorganisations where there is no change in economic ownership. A relatively simple example is the transfer of an asset to a company of which the owner of the asset is sole shareholder. Looking through the corporate veil the transferor still owns the asset and following the Group's principles roll-over relief should be provided. The Group needs to consider whether roll-over relief nevertheless needs to be restricted to prevent it being used for tax minimisation such as when the asset is transferred for debt rather than shares.

75. For the same reason, roll-over relief should be considered for de-mergers.

76. In relation to amalgamations, current law provides a useful starting point. Generally, in an amalgamation between New Zealand companies, roll-over relief means there is no gain or loss for the companies concerned, but there is no roll-over relief for the shareholders in any non-continuing company. In the time available, the Group has not been able to develop any firm or detailed options in relation to these types of transactions.

Intra-group transactions

77. Transactions within a wholly owned group do not give rise to any change in economic ownership. Accordingly, there is a good argument for excluding them from the calculation of taxable income. There is also a risk that if they are included, they will:
    - be used to trigger a deduction for losses that in economic substance are unrealised
    - be used to generate multiple deductions for a single loss.

78. Accordingly, such transactions should be subject to roll-over treatment.

Relationship Property transfers

79. Relationship property transfers of revenue account property are already entitled to roll-over relief and these rules should also apply to included assets.

V How to tax

Tax on capital gains continues to be imposed as income tax and is not a new, different, tax

80. Implicit in the Group's approach is that the income brought into the tax base by taxing more realised capital gains should be taxed in the same way as any other income, unless there is some reason to do otherwise. The rules taxing more capital gains can be seen as no more than expanding the definition of what is a revenue account asset, albeit in a reasonably far-reaching manner.

81. This means:

- taxing income from the realisation (or deemed realisation) of included assets at the person's usual marginal rate, with no indexation for inflation;
- collecting that tax in the same way as income tax is currently collected.

82. This is a key aspect of the Group's design. The proposed design retains the new rules within the existing legislative framework contained in the Income Tax Act 2007 and the Tax Administration Act 1994. This means that:

- there is no need to draft an entirely new set of tax legislation;
- in many respects, existing law will provide all the detailed supporting provisions and mechanisms that are required for the tax to operate;
- the tax will be calculated and collected in a way that is already familiar to taxpayers and advisors;
- existing law may be able to be simplified, once the majority of asset disposals are taxable. For example, it may be possible to repeal the sections defining when sales of land are taxable, once all sales of land other than the excluded home are taxable.

83. However, the Group also acknowledges that modifications to this approach may be needed. For example, most taxpayers whose income is limited to salary and wages, New Zealand dividends and interest, do not have to file a tax return because they have no income from which tax is not withheld at an appropriate rate. Under the proposed extension, if such a taxpayer sells some New Zealand shares, they will have to file a tax return. Some form of withholding tax, either by the buyer or an intermediary, or a transaction-specific return, may be a better alternative, or a useful adjunct, to requiring the person to file an annual tax return. This is considered further in the last section of this Appendix.

Capital gains discount

84. The Group does not propose any capital gains discount because there does not seem to be any sound principle that would require a discount. However, in the event that a discount is thought necessary, rather than taxing capital gains (or some capital gains) at a lower rate, only a fraction of the gains or losses could be included in taxable income. For example, a 50% discount for capital gains can be achieved by taxing 50% of the gain at usual rates, rather than by taxing the entire gain at 50% of the normal rates. Applying a discount or different tax rates to different asset types causes significant classification issues as between capital gain assets and revenue assets. Assets that might crystallise losses are classified into revenue account assets (full deductions for losses) and assets that might increase in value are classified as capital account assets (discounted tax on the gain). Any discounted approach would reduce the amount of legislative simplification that could be achieved and would not be as effective at reducing tax-induced investment distortions.

Inflation adjustment (indexation)

85. With respect to inflation adjustment, there is a strong case in principle for inflation adjustment of cost base. However, there are two good reasons why in practice the case is not made out.

- First, there is no inflation adjustment for any other forms of income. Lenders, for example, must pay tax on all the interest they receive, with no exclusion for the portion that represents inflation. This can have a significant effect on their effective tax rate. Borrowers are similarly entitled to take a deduction for interest with no adjustment for inflation. There is also no inflation adjustment for the cost of trading stock. With a first-in first-out (FIFO) cost flow assumption, the lack of inflation adjustment for trading stock has a similar effect to the lack of inflation adjustment for a long term capital asset. There are also other forms of unrealised income, such as the discount on a zero coupon bond, that do not enjoy either deferral or indexation. Accordingly, it would seem inconsistent with existing policy to index income from sale of capital assets only.

- Second, the lack of inflation adjustment is something of a quid pro quo for taxing on a realisation, rather than accrual, basis. Generally, tax is imposed on income calculated on an annual basis. However, we propose that the new rules apply on a realisation basis. The resulting deferral benefit will counteract, sometimes entirely, the cost of paying tax on the inflation component of a capital gain. For example, suppose inflation is 2% pa and an asset purchased for $1 million appreciates at 7% pa in nominal terms. After ten years, the asset is sold for $1.967 million, of which $0.219 million is inflationary gains. If the inflation adjusted gain were taxed on an accrual basis, the nominal after tax rate of return would be 5.35%. By taxing the nominal gain on realisation, the nominal after-tax rate of return decreases only slightly (in other words, the tax burden increases only slightly), to 5.12%.

86. The interaction between deferral and inflation is shown in the following table. The table assumes inflation of 2%, nominal interest of 5%, and a tax rate of 40%. Based on those assumptions, taxing nominal income produces a nominal tax rate of 40%, while taxing real income produces a nominal tax rate of 24%.

- The first section shows the effective tax rate on nominal interest income after 1, 5, 10, 25, and 50 years, which is 40%.
- The second section shows the effective tax rate on an equivalent capital gain on a realisation basis. Assuming a sale at year 10, the nominal effective tax rate decreases to 35%, demonstrating that the person paying tax on a realisation basis has a lower tax cost than the person receiving a regular income stream, though the rate is still higher than it would be if it were inflation adjusted.
- The third section shows the effect of taxing only 50% of the gain – capital gain discounts are often used as a proxy for inflation adjustments. As the table shows, a 50% discount does much more than adjust for the effect of inflation.
- The fourth section shows the effect of taxing on an inflation adjusted and realised basis. Because the tax is imposed on a realised basis, after one year the rate is lower than 24%.
- The fifth section shows the effect of taxing real gains on an accrual basis, which is that the nominal tax rate is 24%.

Effective Tax Rates on Inflation Adjusted Income
Inflation rate = 2%, Interest rate = 5%

		Year 1	Year 5	Year 10	Year 25	Year 50
1 Fully-taxed interest	Capital build-up	103.0	115.9	134.4	209.4	438.4
	Nominal ETR	40%	40%	40%	40%	40%
2 Realised capital gain	Capital build-up	103.0	116.6	137.7	243.2	728.0
	Nominal ETR	40%	38%	35%	28%	19%
3 Long-term (half-taxed) capital gain	Capital build-up	104.0	122.1	150.3	290.9	937.4
	Nominal ETR	20%	19%	17%	13%	8%
4 Realised indexed capital gain	Capital build-up	103.8	120.7	146.5	268.8	795.7
	Nominal ETR	24%	23%	22%	19%	15%
5 Indexed capital income	Capital build-up	103.8	120.5	145.2	254.1	645.5
	Nominal ETR	24%	24%	24%	24%	24%

87. The Group is concerned about the adverse impact of taxing nominal income with respect to retirement savings. However, it does not consider that this is so much of an issue with property gains and these issues are considered more fully in Chapter 7 on Savings.

Effect on social policy schemes

88. Consideration will also need to be given to how capital gains are dealt with for purposes of entitlements and obligations under social policy schemes such as *Working for Families* and child support. While the eligibility tests may use taxable income as a base, they also deal with many forms of payments that are not taxable income. It may be that changing the tax characterisation of the proceeds of sale of a particular asset makes little difference to the seller's entitlements or obligations under social policy schemes, but this will need to be understood better. The issue can be illustrated by a person receiving *Working for Families* payments through the year. At the end of the year they are entitled to a part of the gain from the sale of a rental property. If this is included income for the purpose of the person's *Working for Families* entitlement they may be required to repay some, or all, of the payments they received.

VI Capital expenditure

89. As a general proposition, the effect of bringing a gain on sale of an asset into the tax base is that expenditure incurred in acquiring that asset will be deductible from the sale proceeds at the time of sale. Various capital costs incurred subsequent to acquisition will also be deductible from the sale proceeds – for example, costs of making significant improvements to the asset. Distinguishing between those asset-related costs which are routine and thus deductible when incurred and those which are of a capital nature (e.g. repairs and maintenance versus improvements) will be the same in this context as it is under current law. The only difference is that under current law, costs which relate to a capital asset are generally not deductible (but may be depreciable).

Building costs

90. Bringing all land into the tax base will mean that all building related costs will be deductible on sale, if they have not already been deducted as incurred or by way of depreciation (recognising that buildings are not currently depreciable).

Cost flow assumptions

91. In the case of fungible assets, such as shares in a company, where a holding may be both acquired and disposed of in a number of transactions, identifying the cost of a particular sale requires assumptions to be made about the identity of the items sold, often referred to as cost flow assumptions. The usual range of assumptions are:
    - the assets sold are the earliest acquired (FIFO);
    - the assets sold are the last acquired (LIFO);
    - the assets sold have the weighted average cost of the assets held at the time;
    - the assets sold are those selected by the taxpayer.

92. Which assumption applies can have a significant impact on the profit from sale. On the basis of rising prices, FIFO will produce more income from sale than LIFO, with weighted average cost in the middle.

93. Current law relating to trading stock generally requires taxpayers to use either FIFO or weighted average cost. The method adopted must be consistent with the person's financial accounts. For other property on revenue account, specific identification of the asset is used. These matters are still under consideration.

Personal assets in the base

94. The Group proposes that gains on all land other than the family home be included in the tax base. This raises an issue as to the deductibility of expenses incurred in relation to such land where it is not used for revenue-producing purposes. An example is a family bach which is not rented out. The issue also arises for family baches which are rented out on a less than 100% basis, but only to the extent that expenditure is non-

deductible due to the private limitation, generally as determined by the mixed use asset rules.

95. Expenses relating to the private enjoyment of the bach should not be deductible. The Group proposes that all expenditure which would be immediately deductible if the bach were fully rented out should be treated as relating to private enjoyment, and all expenditure which would have to be capitalised should be treated as part of the cost of the bach and deductible on sale. This means that:

- rates, insurance and interest costs would remain non-deductible;
- costs such as installing a swimming pool will be deductible when the bach is sold.

96. This approach is not altogether theoretically satisfactory. Costs incurred in acquiring depreciating assets, such as a swimming pool, should not be fully deductible on sale. The portion of the costs that is deductible on sale should only be the market value of the depreciated assets, since the assets have been used to generate a private benefit in the interim. However, due to concerns about complexity and compliance costs the Group does not propose any adjustment be made to reflect this.

Assets introduced into the base

97. In some cases, assets will enter the base other than by way of being acquired. Examples are:

- assets held by a person who migrates to New Zealand;
- assets owned by a person which are converted from private to business use;
- a house which a person ceases to use as a family home, for example, if the person moves to a new family home and rents out the former family home.

98. Consistent with existing law, the Group proposes that such assets enter the tax base at their market value at the time of introduction. This would generally require a valuation of the property. Where an excluded home ceases to be an excluded home, rather than requiring the owner to incur the expense of a valuation, it may be acceptable to rely on a recent ratings valuation, or an interpolation of the ratings valuations immediately before and immediately after the sale. The Group will consider this issue with an aim of developing a proposal that will not jeopardise revenue while minimising compliance costs so far as possible.

99. Because of the subjectivity inherent in valuations, where a valuation figure would produce a loss (i.e. is higher than actual sales), it may be desirable to either ring-fence that loss, or use the median rule, as we propose for transitional valuations (discussed below).

VII Treatment of capital losses

100. From an economic perspective, it is desirable so far as possible that the tax treatment of gains and losses be symmetrical. Ideally, this would mean that net losses are refunded in cash. However, this is not desirable from a revenue perspective, and such losses are instead able to be carried forward or (in the case of corporate groups) grouped. At the level of an individual transaction, the benefit of a loss-making transaction can be claimed immediately if the taxpayer has a net profit for the year.

101. Taxing capital gains on a realisation basis raises a particular problem in this respect. Because taxpayers can decide whether or not to sell an asset in a particular year, they can choose to sell depreciated assets in order to accelerate the tax benefit of the loss and retain appreciated assets in order to defer the tax cost.

102. This kind of cherry-picking is particularly problematic:

- in the case of fungible assets, where the sale of a depreciated asset to realise a tax loss can be followed immediately by the acquisition of an identical asset. Effectively, the taxpayer can return losses on an accrual basis and gains on a realisation basis;

- in the case of traded assets where there is also a traded hedge. Taxpayers can generate a tax loss with very little economic cost or risk by acquiring offsetting assets (for example, a call and a put over the same shares) and selling the asset with a loss just before the end of the year, then selling the asset with a gain just after. This is often referred to as a straddle transaction. The ability to use straddle transactions to generate tax benefits may be diminished in New Zealand to the extent that the assets which would be used in such transactions are financial arrangements and so already subject to comprehensive taxation on some form of accrual basis.

103. In many countries, these issues mean that capital losses are ring-fenced, so that they can only be used against capital gains.

104. For assets that are not fungible, there is of course a real consequence of selling a loss-making asset, as well as a tax consequence. The seller has given up its exposure to the asset, and thus the chance to recoup its loss. Similarly, a person who retains an appreciated asset is taking the risk that the asset will decline in value.

105. At this stage, the Group proposes that ring-fencing of losses apply to:

- Portfolio listed shares and derivatives that are not already treated as financial arrangements. Losses should be able to be offset only against capital gains and dividends from such assets.
- Land held for private purposes. Such losses should be non-deductible altogether, on the basis that they represent private consumption.
- Losses arising from non-market transactions.

106. However, the more extensive the roll over relief the more there may be a need to widen loss ring-fencing. That is because extensive roll-over relief would be likely to defer taxing gains, creating more opportunity to defer gains but realise losses. In any case it is the expectation of the Group that officials would monitor the use of losses under the new rules and extend loss ring-fencing if that is justified by revenue risk.

VIII Transitional rules

107. In general, capital gains taxes have been introduced in other countries either:

- for all affected assets, with effect from a certain day, i.e. on the basis that gains and losses from that day on are in the base (this was the approach taken by the Republic of South Africa);
- only for assets acquired on or after a certain day (this was the approach taken by Australia when it introduced a general capital gains tax in 1985).

108. The second approach allows taxpayers to retain assets acquired before introduction of the tax and continue to earn tax free capital gains. The advantage of the Australian approach is that it largely removes the need for extensive valuations on implementation date, the significant compliance costs and room for associated disputes. However, the Group understands it is not uncommon, more than 30 years after the introduction of capital gains tax in Australia, to find taxpayers who are still able to accrue tax-free gains because they have not sold assets acquired before the introduction of the tax. This is likely to lead to distortions in asset ownership and would significantly defer the achievement of the objectives sought by introduction of the tax. Accordingly, on balance, the Group's view at this stage is that the "valuation day" approach be adopted.

109. As noted, a valuation day approach does mean there is a need to value all assets that are to be subject to the new rules as at a given day. This will impose a significant cost on many taxpayers for certain asset types. For listed shares and other market traded assets this should be relatively straightforward in most cases, but it will impose compliance costs, and may be unreliable, for other assets. For example, obtaining a reliable value for a private company, or of goodwill associated with a business, is likely to require significant time and expense. There is also a risk that taxpayers will overstate these values, so as to minimise gains/create losses when the relevant assets are eventually sold. The consequences of over-statement are higher if there is no ring-fencing of losses.

110. There are at least two ways to address these issues, which can be applied separately or in tandem.

111. One way is to apply a median rule, which the Group understands was the approach taken in Canada. Under this approach, in calculating the gain or loss from an asset held on the valuation day, the taxpayer's cost in the asset is the median of:

- actual cost, including costs incurred both before and after valuation day;
- value on valuation day, plus costs incurred after valuation day;
- sale price.

112. The median rule means that a valuation day value which is higher than actual cost cannot increase a deductible loss on sale above the actual loss (since the median figure will be actual cost). This is some protection against losses being claimed because of inflated valuations. It also means that a valuation day value which is lower than actual cost cannot increase a taxable gain above the actual gain (for the same reason). If an asset has had past losses these can be recouped up to the level of future gains. This rule would be adopted for all assets, other than possibly for listed assets.

113. To illustrate the median rule, suppose an IT start-up business is operated by a special purpose company where the three employees and their relatives are also the principal shareholders. The company incurs running costs of $25,000 per year and salaries of $40,000 for each employee. The company is funded by issuing shares. On valuation day the company has made no sales, but there are hopeful signs, and a registered valuer values it at $1.5 million. One year after the tax is introduced, the company is wound up, returning nothing to its investors, who have contributed $600,000 over the four years of its existence, $100,000 of which is incurred after the valuation day.

114. The investors' gross revenue from sale is $0. The median value of the shares is therefore the median of:

- $0 sale proceeds;
- $1.5 million valuation plus $100,000 incurred after valuation, for a total of $1.6 million;
- $600,000 cost.

115. The median figure is $600,000, and that will be the aggregate loss in respect of the shares, which will be divided between the shareholders in accordance with the amount they invested in the company.

116. It is important to understand how the median rule applies when a person incurs post-valuation day costs which have to be capitalised. As in the above example, these costs are added to the valuation day value. This should generally ensure that the impending introduction of the tax does not affect decisions as to when capital expenditure is incurred. For example, suppose a person owns a building damaged by an earthquake. The cost of the building before the earthquake was $8 million. The value of the building immediately before the earthquake was $12 million. The earthquake reduced the value to $9 million. The owner intends to pay $3 million to bring the building up to code, which will restore the value to

$12 million. If this money is spent before the valuation day for the new rules, then the value of the building on valuation day will be $12 million and the cost will be $11 million. If the money is spent after the valuation day, then the valuation figure will be the $9 million valuation plus the $3 million of post-valuation day costs for a figure of $12 million. Cost will again be $11 million once the repairs are done. The tax treatment of any sale should be the same, regardless of when the repairs are done.

117. The median rule does not deal with compliance cost issues. In order to deal with compliance cost issues, the Group believes consideration should be given to developing acceptable rules of thumb. In particular, these might include:

- using rateable value (RV) for real property, plus any capital costs incurred since the date the RV was published;
- where taxpayers apply IFRS rules requiring assets to be valued at fair market values, the value adopted under those rules;
- at the taxpayer's election, allowing taxpayers with hard to value assets to pro rate the actual gain or loss on a time basis, though this may be difficult with assets whose cost base includes a number of items of expenditure spread over a number of years, or where taxpayers are unlikely to have kept a track of cost base, such as goodwill.

118. Consideration should also be given to whether these rules are appropriate in other transitional situations, for example when a person migrates to or from New Zealand, or a house becomes or ceases to be a family home.

IX Taxation of shares in foreign companies

119. In order to explain the issues arising from extending the taxation of gains on sale of assets to foreign shares, the existing tax treatment must be first understood. The issue then is how this treatment might be modified if gains on sale of assets became generally taxable.

Current taxation of New Zealand residents investing in foreign companies

120. New Zealanders investing in shares in foreign companies are taxed under one of three different regimes. Broadly:

- The controlled foreign company (CFC) regime applies to interests of 10% or more in foreign companies that are (generally) 50% or more controlled by 5 or fewer New Zealand residents, other than interests in companies resident in Australia.
- The foreign investment fund (FIF) regime applies to all other interests in foreign companies, other than
  - for interests of more than 10%, companies resident in Australia;
  - for interest of less than 10%, listed companies resident in Australia;
  - interests held by a person whose total foreign share portfolio cost less than $50,000 to acquire, if the person elects not to return FIF income.
- For interests not taxed under either of the above regimes, shareholders are generally:
  - taxable on dividends, unless the shareholder is a company holding at least 10% of the company, in which case the dividends are exempt;
  - subject to tax on sale only if they hold the shares on revenue account.

121. Under the CFC regime:

- The shareholder's share of income earned by the foreign company is taxed to the shareholder as it is earned by the foreign company if the income is "attributable foreign income" – essentially income that could just as easily have been earned directly in New Zealand. There is generally no attribution for active foreign business income because it does not meet this test.
- Dividends are only taxed if the shareholder is not a company.
- Gains on sale are only taxed if the shares are held on revenue account.
- Foreign tax imposed on the relevant income is generally able to be claimed as a tax credit against New Zealand tax.

122. The FIF regime provides for a number of different taxing methods depending on the level of shareholding in the foreign company. But in general taxpayers with less than 10% holdings must use either:

- the fair dividend rate (FDR) method, which taxes the shareholder each year on 5% of the annual opening value of its foreign share portfolio, and takes no account of dividends or actual gains and losses (though foreign withholding tax on dividends are creditable against the tax on FDR income); or
- the comparative value (CV) method, which taxes the shareholder on dividends plus accrued gains and losses during the year.

123. Other methods are provided for hard to value shares.

124. Generally shareholders are required to use the FDR method, except for shares which are close substitutes for debt. Natural persons and family trusts may choose in any year to apply the CV method to their foreign share investment portfolio. In this case, however, they are not able to claim a deduction for any loss.

125. This pattern of taxation reflects a range of different objectives including a desire to prevent foreign companies being used to defer the imposition of New Zealand tax. For purposes of this Report, the only issue is how and whether it should be modified to deal with the new rules.

CFC interests

126. An issue that we have considered is defining when capital gains of a CFC are to be attributed foreign income or not. Generally, this should be evident from the nature of the income produced by those assets, or the nature of the business in which they are used. If a CFC earns only non-attributed income it logically follows that any gains on property would be non-attributed income.

127. A second issue is the taxation of any gains or losses made by the shareholder from sale of a CFC interest. In relation to an interest in a non-attributing CFC, the objectives of the current CFC regime suggest it would not be appropriate to tax gains on sale of such an interest by a company. Currently neither attributed income, nor actual distributions, from such an interest are taxed. This ensures that New Zealand companies investing in foreign businesses are not taxed more heavily than local residents, or other foreigners making the same investment. It is an approach that is widely adopted. It would run counter to this approach to tax the gain on sale of such a CFC. Furthermore, such a tax could at least in some cases be avoided by the company paying a dividend to its New Zealand shareholder which would be exempt.

128. The Group notes this does mean that such gains are likely not to be taxed at all at the time they are derived, since the country where the CFC is resident will generally not tax unless the CFC is land rich. However, the gain will in effect be taxed either when it is distributed (with no imputation credits) to New Zealand resident shareholders, or when a shareholder in the New Zealand holding company sells its shares, if that sale is subject to tax (as would be the case under the proposal).

129. If the shareholder in the non-attributing CFC is not a company, then the gain on sale of the shares should be subject to tax in the usual way, just as a dividend would be taxable.

130. The same reasoning means that gains on sales of shares in an attributing CFC should be taxable to any New Zealand resident shareholder. Losses should similarly be deductible, but this should be subject to loss ring-fencing, applying the same rules as currently exist for attributed foreign losses.

131. A CFC may derive some attributable and some non-attributable income (if attributable income is less than 5% of total income, it is not attributed). In this case the gain could be taxable (or loss deductible) in the same proportion as the proportion that the value of assets giving rise to attributable income bears to the value of all assets in the CFC, over some period of time. The Group understands that a similar approach is taken in Australia. Should New Zealand not mirror the Australian rules then the expectation is that any New Zealand company with active CFC income would have an incentive to relocate to Australia.

FIF interests

132. A significant benefit of the current FIF regime – in particular, the FDR rules taxing foreign shares on a 5% deemed return – is that investment by a New Zealand resident in foreign shares is subject to New Zealand tax even when the foreign company does not pay a dividend and even when the shares are not sold for many years. In addition, our tax rules for KiwiSaver and similar investment entities substantially rely on the FDR rules to make their rules governing interaction with their investors possible to operate. Accordingly, there seem to be real advantages to retaining FDR, rather than moving to taxing only actual dividends and realised gains. Retention of the FDR regime for FIF investments is the Group's preferred approach at this stage.

133. The Group notes that the fall in risk-free rates of return since FDR was introduced in 2007 indicates that the 5% FDR rate could now be too high, even in the context of a system which ordinarily taxes both gain on sale and dividends. The secondary market 1 year government bond yield has fallen from 6.99% in 2007 to 1.77% and the 5 year rate has fallen from 6.5% to 2.14%. We are still considering this issue and at the same time are considering removal of the CV option for individuals and family trusts.

Other interests

134. In relation to portfolio interests in Australian listed companies, not subject to the FIF regime), it seems appropriate to simply tax realised gains and losses, in the same way as is proposed for other assets. However, this treatment may have to be modified for investment by portfolio investment entities, as discussed later.

135. In relation to other interests in Australian companies, the treatment proposed above for non-attributing CFCs may be appropriate, i.e.:

- exemption for New Zealand companies;
- taxation on a realisation basis for all other owners.

X Taxation of non-residents

136. Where possible, the rules that currently apply to tax non-residents on their New Zealand-sourced income should also apply to income in the form of capital gains. This will generally mean taxing property located in New Zealand, and not taxing property located elsewhere.

137. In the case of land, the result of applying the location test is obvious. The same applies to physical property. Location is somewhat less obvious when applied to debts, shares and other intangible property, though rules have been developed to determine it. Some of New Zealand's tax treaties remove the right to tax the residents of treaty countries on the sale of assets other than New Zealand land, New Zealand land-rich companies (wherever resident), or assets of a New Zealand branch,

though most do not remove that right. Where the right is removed, it is in return for similar treatment of New Zealand residents by the treaty country. This is also the position taken in the OECD Model which influences the double tax agreements New Zealand has entered into with other countries. Many countries with broad-based capital gains taxes have similar limitations in their domestic law. The domestic law limitations can go further – for example, even sales of shares in land-rich companies could be exempt if the shareholder and their associates do not hold more than a certain percentage (say, 10%) of the company. This exception can apply to all companies, or only those that are listed.

138. The Group proposes that in line with the practice generally adopted in other countries, non-residents should only be taxed on sales of:

- interests in land located in New Zealand (broadly defined, so that it includes for example any right relating to physical resources in New Zealand);
- interests in companies deriving more than half their value from New Zealand land, unless the non-resident is a portfolio investor in a listed company[81];
- assets of a New Zealand branch.

XI Taxation on migration

139. If no tax is imposed when a person migrates – or, more specifically, terminates tax residence in New Zealand – then migration will be a simple way to avoid a realisation-based capital gains tax. In fact, there will be an incentive to migrate for the owners of appreciated assets. For example, a New Zealand resident with a significant tax-free gain on land in a foreign country would have an incentive to migrate before selling the land, unless there is a deemed tax on migration.

140. An option for dealing with this problem is to deem assets to be disposed of for market value upon migration. Deemed disposal could be limited to those assets that cease to be subject to tax on sale when a person becomes non-resident. So, for instance, it might not apply to ownership of land in New Zealand, but would apply to ownership of land outside New Zealand. We are considering whether a deemed disposal could also be made optional, as we understand is the case in Australia, so that a natural person migrant could elect to remain taxable with respect to the asset. For that person the asset would remain an included asset and the person would be taxable in New Zealand on it for the full gain on sale. This protects temporary migrants from being taxed on assets when they leave and then return still holding the asset. It also better provides for the avoidance of double tax on the same income by use of double tax agreements.

141. When a person migrates to New Zealand, they should similarly be treated as having acquired their assets for market value on the first day they become New Zealand tax resident (or, in the case of a transitional resident, become a resident who is not a transitional resident).[82] This will establish their cost base for the purpose of taxing subsequent sales. However, sales of non-New Zealand property made by a transitional migrant would not be subject to tax.

XII Taxation of partnerships and look-through companies (and their owners)

142. Extending the taxation of gains from capital assets does not seem to raise any particular additional issues for fiscally transparent entities such as partnerships and look-through companies (LTCs). Gains and losses from sales of relevant assets by these entities will become taxable or deductible, and

81 Unless there is a specific over-ride, some treaties may over-ride the imposition of tax in this case.

82 Setting the cost base by reference to the date the person ceases to be a transitional resident is the approach already adopted in the financial arrangement rules – see section EW 41(1)(b).

these gains or losses will be allocated to the partners or shareholders in the same way as other taxable gains and losses are allocated. Sale of a partnership interest or a share in a look-through company should be treated as a sale by the shareholder or partner of its share in the relevant assets.

143. The Group notes that there are currently a number of de *minimis* rules in the LTC and partnership provisions, that allow gains and losses on disposal of LTC shares/a partnership interest to be ignored. The continued appropriateness of these provisions in the context of an extended tax on capital gains on sale will need to be considered.

144. The Group does not propose any change to existing law regarding entry and exit of a new partner. Entry of a new partner is treated as a sale by the existing partners of an interest in the partnership assets to the new partner and exit of a partner is treated as a sale by the exiting partner of its interest in the partnership assets to the continuing partners.

145. Treatment of a new partner as having acquired an interest in the partnership assets can give rise to complexity, due to the fact that the new partner may have a different cost in its share of the assets than the other partners. This issue already applies to depreciated property and the proposed reform will exacerbate this issue. Accordingly it needs to be considered in more detail as part of the reform.

146. The Group understand that Inland Revenue treats:

- a contribution of a revenue account asset to a partnership in exchange for a partnership interest (or an increased interest) as a sale of the entire amount of the asset contributed (despite the contributing partner's retention of an interest in the asset); and
- a distribution of a partnership asset in specie as a 100% sale for market value.

147. The Group's view is that the same approach could apply to assets to be included in the new rules.

XIII Taxation of companies

148. The Group proposes that assets held by companies should in most cases be subject to the rules taxing realised capital gains in the same way as assets held by individuals. The only difference would be for sales of shares in group companies. The taxation of sales of shares by companies, along with other issues for corporate groups, is considered in a separate section.

XIV Taxation of New Zealand shareholders in New Zealand tax resident companies

As a general proposition, taxing gain on sales of shares is appropriate, but there are issues

149. As a general proposition, it seems logical to tax share gains under the proposed rules just as we tax the gains made by investing in other property. The issue however is that our imputation system treats companies as in effect agents for shareholders. The company derives income in its own capacity but it derives that income for the benefit of shareholders. We should tax that income either at the shareholder level or at the company level but not both. We do currently tax companies on their income and shareholders on dividends but the imputation system allows company tax to be credited against tax on dividends. Under the rules if we are to tax share gains at the shareholder level, as well as taxing the company on gains earned by the company then we could tax the same gains twice.

150. However, not taxing shareholders on share gains would seem to undermine the integrity of the extended rules. In effect shareholders could realise untaxed gains by selling shares. The company would be taxed on gains it makes but that could allow for significant deferral of tax. The objective of taxing share gains is to limit this deferral and not to double tax equity.

151. However, taxing gains on sales of shares raises double tax/double deduction issues that the Group is considering. For example:

- To the extent the company has taxed retained earnings at the time of a share sale, taxing the portion of the sale price attributable to those earnings is double taxation (double taxation of retained earnings).
- To the extent the company owns an asset which has increased in value during the time the shareholder owns its shares, the sale will impose tax on a portion of the gain (the amount the share buyer is prepared to pay for that gain). If the company sells the asset post-sale of the shares, imposing tax on the full amount of the gain is double taxation (double taxation of unrealised gains).
- To the extent that a company has realised losses which are not eliminated by the share sale, the sale will give rise to a double deduction, once for the company when the losses are used (by the company or another company under loss grouping) and once for the selling shareholder when the shares are sold (double deduction of realised losses).
- To the extent the company owns an asset with unrealised loss at the time of a share sale, the sale will crystallise a deduction for that loss. If the company sells the asset post-sale of the shares, allowing a deduction for the full amount of the loss is a double deduction (double deduction for unrealised losses).

Double taxation of realised gains

152. In the Group's view, the double taxation of retained earnings does not require any legislative response if a company realises a taxable gain and then distributes that as an imputed dividend. The imputation system operates to remove double taxation. Distributions can be "virtual", by way of the company making a bonus issue of shares which it treats as a taxable bonus issue. The bonus issue will increase the tax cost of shareholders' shares, and therefore reduce their taxable gain on sale. Frequent taxable bonus issues also have the merit of ensuring that corporate income is taxed at the shareholders' marginal rates. The Group appreciates that taxable bonus issues may not be appropriate in all cases, particularly for listed companies. Double taxation also "washes out" once the retained earnings are distributed to the share purchaser and the share purchaser on-sells the shares.

153. For example, suppose a company has $7,200 of after-tax earnings, on which tax has been paid at the full 28% rate. If a 10% shareholder sells its shares in the company before these earnings are distributed, and the sale is taxable, the Government will collect tax twice on the portion of the sale price attributable to those earnings. However, there will be no double taxation:

- if the company distributes the earnings as a dividend before the sale; or
- if the company makes a fully imputed taxable bonus issue of shares with a tax value of $7,200. Assuming that no shareholders have a certificate of exemption from resident withholding tax (RWT), this would involve the company:
  - issuing shares and electing for those shares to have a taxable value of $6,700;
  - paying $500 of RWT;
  - attaching $2,800 of imputation credits to the dividend.

  The 10% shareholder would then hold shares with the same value as before, but an increased cost base for tax purposes of $670. This would reduce the shareholder's gain on sale; or
- once the purchaser receives a distribution of the retained earnings and then sells the shares. For example, suppose there is no dividend or bonus issue. The purchaser of 10% of the shares pays an additional $720 for the retained earnings in the company at

the time of sale[83]. This means that taxable income of only $1,000 (at the level of the company) has given rise to total taxable income of $1,720. However, suppose that the earnings are then distributed to the purchaser, and then purchaser then sells its shares in the company:

– The distribution of the retained earnings will not give rise to any additional taxable income (in effect), by virtue of the attachment of imputation credits to the dividend (though the payment of a dividend may change the rate of tax imposed).

– The price for the on-sale of the shares (now ex dividend, i.e. conveying no interest in the retained earnings) by the purchaser will be reduced by virtue of payment of the dividend. Assuming again that the effect of the retained earnings was to increase the price of the shares by $720, the price reduction once the retained earnings are gone will also be $720.

This second sale will reverse the double taxation that arose on the first sale, by allowing the purchaser a net deduction for the amount paid to acquire the retained earnings. However, this benefit may not arise for some time. Accordingly, taxing share sales may cause companies to distribute more of their taxable earnings, either as cash dividends or as taxable bonus issues.

154. Given the existence of the taxable bonus issue solution, and the fact that New Zealand listed companies tend to distribute a relatively high proportion of their taxable income in any event[84], the Group's view at this stage is that the issue of double taxation of retained earnings (gains taxed first at company level and then again at shareholder level) may be able to be managed in practise under the existing imputation rules and might not require a new legislative response. The Group notes that Australia does not provide any legislative remedy for this issue, even though its law does not provide for taxable bonus issues.[85]

155. One exception relates to the continuity rule for imputation credits. To the extent that a share sale eliminates imputation credits, payment of a post-sale dividend will not solve the double taxation issue. The Group understands that Australia's rule for imputation credit continuity is considerably narrower than the New Zealand rule, and focuses on situations where a company with non-resident owners (who cannot use imputation credits) becomes owned by residents (who can). The Group's view is that if the new rules on taxing capital gains are implemented, then the restrictions on imputation continuity should be relaxed in a similar way in order to minimise the risk of double taxation.

Double taxation of unrealised gains

156. The second possible source of double taxation relates to unrealised gains. For example, suppose:

- a company holds an asset with an unrealised gain of $10,000, at the time that a 10% shareholder sells its shares in the company;
- the sale price for the 10% holding reflects this appreciation (less deferred tax), i.e. that it is $720 greater than would otherwise be the case (being 10% of $10,000 less 28% tax);
- shortly after sale, the company sells the asset for a $10,000 gain.

In this case, 10% of the gain on sale of the asset has been taxed twice.

83 Given the imputation credits in the company, the actual additional amount may well be more than this, though it should not exceed $1,000.

84 An analysis of NZX sharemarket data shows that imputation credits of large companies amount to about 1.8% of their market capitalisation, showing there is not a significant build-up of undistributed taxed income. See *Imputation and the New Zealand Dividend Psyche* (EY 2015).

85 Though Australian rates of capital gains tax are much lower than the marginal rate, not least because superannuation funds, taxed at 10% on capital gains, are significant investors in the share market.

157. It will generally not be possible to deal with this situation by way of a pre-sale distribution or taxable bonus issue, since at that time no gain has been realised. The double taxation can only be eliminated once the gain is distributed and the purchaser sells its shares.

- The distribution to the purchaser will not give rise to any additional income (again by virtue of the attachment of imputation credits).
- The purchaser will sell the shares for a price that does not include the appreciation in the asset's value but will be entitled to a deduction for its cost price which does include that appreciation.

158. In unlisted companies, these kinds of issues may be able to be dealt with by way of the purchaser acquiring the assets of the company or liquidating the company shortly after selling the assets. Another possibility is to allow the parties to elect to treat a sale of all of the shares in a company as though it were a sale of the assets. For example, the purchaser and seller could elect that:

- the company be treated as having distributed all of its assets to the seller for their tax value (so no gain or loss to the company);
- the seller be treated as selling the assets to the purchaser for the transaction value (giving rise to gain or loss to the seller, equal to the difference between the transaction value and the seller's cost in the shares);
- following which the purchaser would be treated as contributing the assets to the company for their transaction value (so no gain or loss for the purchaser), and:
  - – purchaser has a market value basis in the shares;
  - – company has a market value basis in its assets. Because the company has a market value basis in its assets, sale of those assets will not trigger tax on gain accrued before the share sale.

159. This is an issue the Group is still considering.

Double deduction for realised losses

160. Mirror issues potentially arise for companies with realised and unrealised losses. For example, suppose a company with a $10,000 taxable loss, which has not been grouped. If a 10% shareholder sells its shares in the company, the price will generally reflect the existence of the loss. The sale will not give rise to a double deduction, since the corporate loss is not refunded but carried forward (subject to the continuity of ownership requirement). However, if the company generates $10,000 of income in the period post-sale, the loss will effectively have given rise to two deductions. Again, this benefit will be recaptured when the purchaser sells the shares in the company or pays unimputed dividends. The sale price will reflect the increase in the company's value as a result of the $10,000 of income generated post-sale.

161. In relation to realised losses, the Group does not propose any response to the possibility of double deductions, except where the company has grouped its loss by way of a loss offset election before the sale. A rule of this kind already exists. A person is denied a deduction for a share loss in relation to shares in a company which has grouped a loss with another company. However:

- this rule applies only to corporate vendors;
- the introduction of a generally applicable tax on gains and losses from share sales means this provision needs to be reviewed to ensure it is effective, and whether it is the best way to deal with this problem.

162. Double deductions in a corporate group are considered further below.

Double deduction for unrealised losses

163. In relation to sale of a company with unrealised losses, the Group considers that some response should be developed to the problem of deductions at both the shareholder and corporate level. This could, for example, be a requirement that if more than 50% of the shares in a company are sold for a loss, the kind of mechanism referred to above to avoid double taxation of unrealised gains could be made mandatory.

Distribution of untaxed gains

164. Currently, companies are able to distribute capital gains tax free on liquidation. The purpose of this rule appears to be to allow the capital gain preference to apply to assets held through companies, though concerns about ordering/streaming mean that the capital gains preference only applies to distributions on liquidation.

165. To the extent that assets which are currently on capital account are brought within the tax base, gains on sale will become taxable, and it will clearly no longer be necessary to allow those gains to be distributed free of tax. Capital gain distributions will accordingly become much smaller over time. However, where gains would not be taxed to shareholders if the relevant assets were held directly (or, in the case of a non-asset related receipt, if the relevant amount were received directly) there is no obvious reason for changing the current provisions which allow capital gains to be distributed tax free.

166. The Group has considered three cases in particular in this respect:

- Sales of shares in CFCs by a company. The Group considers that gains from the sale of shares in a non-attributing CFC should not be taxed if the seller is a company, but should be taxed otherwise. Accordingly, such gains made by a company should not be able to be passed through tax-free to shareholders, unless perhaps the shareholder is a company which also would not have been taxable on the gain.
- Sales of shares in FIFs by a company, assuming that these remain subject to the FDR method. Gains in excess of FDR income are treated as capital gain amounts (see in particular section CD 44(8C)). Tax-free treatment of such distributions should continue, since it produces the same result as direct ownership by the shareholder.
- Unrealised capital gains accrued before the introduction of the tax. Transitional relief means these gains are not proposed to be taxed to the company. In order to preserve this benefit, distribution of such gains on liquidation should also be tax-free.

167. To illustrate this last point, suppose the following facts. Before the extension of income from capital, Shareholder A contributed $200,000 to A Ltd, which used the money to buy a rental property, with no debt. On the day the tax is introduced, the property is worth $300,000 and this is also the value of the A Ltd shares. One year later the property is sold for $330,000 and A Ltd is wound up.

168. A Ltd will be taxable on $30,000 of its $130,000 gain. At a 28% rate, the tax owing is $8,400. $21,600 can be distributed as a fully imputed taxable dividend. The remaining $100,000 of gain can be distributed as a capital gain amount. Shareholder A will receive a distribution of $321,600 (the sale proceeds less tax). $21,600 will be a fully imputed dividend. The rest of the amount ($300,000) will be treated by Shareholder A as proceeds of sale of shares. Since Shareholder A has a cost base for tax purposes of the value of the shares on the date the tax was introduced, i.e. $300,000, Shareholder A will not be taxed on any of this amount.

169. Suppose instead that Shareholder A sells A Ltd to Shareholder B for $310,000 in between the effective date for the tax on the one hand and the sale of property and distribution of the sale proceeds on the other. There is no change to the company's tax position. However:

- Shareholder A now has a pre-CGT capital gain of $100,000 and a taxable gain of $10,000. The $10,000 is the difference between the actual sale price to Shareholder B and Shareholder A's deemed tax cost of $300,000.
- Shareholder B has a dividend of $21,600 fully imputed, plus a loss on sale of $10,000, being the difference between the non-dividend amount received on liquidation ($300,000) and the amount Shareholder B paid for the shares ($310,000).

170. The amount of income recognised is the same in either case. There is $30,000 of income at the corporate level, and no net income at the shareholder level.

Qualifying companies

171. Qualifying companies are able to pass out capital gains to shareholders on a tax-free basis without having to liquidate (other companies can only distribute capital gains to shareholders tax free on liquidation). This regime now applies only to companies already in the regime on 31 March 2011 and is subject to ownership continuity. The only benefit of a qualifying company is the ability to distribute capital gains tax free but be taxed at the lower 28% company tax rate. Under the proposed rules there would be no future tax free capital gain so the regime would seem redundant. On that basis the Group is considering recommending the repeal of this regime.

Winding up of a company

172. Currently, the tax rules treat amounts distributed on the winding up of a company as being first a return of available subscribed capital, second distribution of net capital gains, and lastly a dividend. The first two amounts are generally not taxable. The Act also provides that amounts which are taxable as dividends are not also taxable as sale proceeds. We do not consider this would need to change under the proposed rules in terms of the tax outcome. However, we need to consider further the rules distinguishing between returns of capital, distributions of capital gain, and dividends. The distinction will be particularly important for non-resident shareholders, who may face different levels of tax on dividends and capital gains. The policy objective is that realised or unrealised capital gains that arose before the implementation date of the new rules would remain able to be distributed free of either taxation on dividends or tax on gains related to those historical capital gains.

XV Taxation of trusts

General

173. The taxation of contributions to, and distributions by, trusts has been considered above in the section on roll-over relief. As with companies, extension of the taxation of income from capital should apply to assets held by trusts in the same way as it applies to assets held by individuals.

174. Under this approach, the current approach to taxing trust income would continue to apply. That is, there would be a single layer of income, taxable to either the trustee or a beneficiary. Distributions (other than of beneficiary income) from complying trusts (whether in cash or in kind) would continue to be tax-free to the beneficiary in all cases on the basis that tax has already been paid as trustee income. Distributions from foreign trusts would be tax free to the beneficiary only if they represented corpus or realised capital gains. Realised capital gains would not include gains which are taxable under the new rules.

Avoidance

175. The realised capital gains tax rules may prompt some taxpayers to look for ways to transfer assets without paying the tax. One way this might be achieved is by way of holding the assets in a trust and then "transferring" the trust. While it is not generally possible for a beneficiary of a trust (other than a unit trust which is treated as a company for tax purposes) to transfer its interest to another person for consideration in a way that would give the transferee enforceable rights against the trustee, in the case of a discretionary

trust, a change of trustees, or a change of the control of a corporate trustee, may be used to achieve an effective transfer of ownership of a trust's assets.

176. The Act already contains a rule that treats certain changes in a trustee or a trust deed as triggering a deemed disposal of property held by the trust, if the purpose of the change is to defeat the bright line rule in the land taxing provisions. A similar rule would be needed to support the rules taxing capital gains.

XVI Taxation of KiwiSaver and other managed investment entities

177. Since the introduction of KiwiSaver and the portfolio investment entity (PIE) regimes in 2007 most managed investment in New Zealand has been through PIEs, though some workplace saving still takes place through superannuation schemes outside the PIE rules.

178. This section considers how the proposed extension of the taxation of income from capital would apply to:

- KiwiSaver saving through a multi-rate PIE (MRPIE) in the form of an open ended investment fund. Most KiwiSaver saving is through MRPIEs of this sort;
- a MRPIE that is a closed end property fund. This is another relatively common form of PIE;
- a listed PIE;
- a superannuation fund.

179. It is important to ensure that any tax extension in relation to income from capital takes these vehicles into account, given their important role in investing New Zealanders' capital. It is also important to recognise that investments can be made directly or through vehicles. So far as possible, the tax rules should maintain a level playing field between those choices.

KiwiSaver investment through MRPIEs

180. Key features of the MRPIE tax regime, which should not be disturbed by the new rules if at all possible, are:

- imposition of only one level of tax;
- imposition of tax at portfolio investor rates, generally lower than but related to the investor's marginal tax rate;
- income calculated on the same basis as it would be if an individual invested directly;
- keeping tax "outside the fund", so that it is treated as an investor level expense rather than a fund level expense.

181. For most assets held by MRPIEs, the new rules will have no effect:

- Debt investments are already comprehensively taxed under the financial arrangement rules.
- Portfolio shares, other than Australian listed and New Zealand shares (for this purpose, referred to as "foreign shares" and "Australasian shares" respectively), are proposed to continue to be subject to the FDR regime.

182. The new rules would only affect MRPIEs investing in property and in Australasian shares although these constitute a material part of many KiwiSaver and other managed fund investments. Under current law, a gain on sale of Australasian shares by a PIE is specifically tax exempt, and gains from sales of property are generally on terms that mean that they too are not taxed. This aligns the taxation of assets held by MRPIEs with the taxation of assets held directly by natural persons or trusts (in most cases). However, under the new rules, gains from sales of these assets will prima facie be taxable to natural persons and trusts, so it follows that they should also be taxable to a PIE.

183. Feedback from advisors and industry suggests that imposing a realised capital gains tax on such assets held by MRPIEs, while retaining the benefits of the MRPIE tax

regime, would require significant systems changes, amongst other practical issues. This appendix attempts to describe the issue that applying a realised capital gains tax would cause. It then goes on to consider some other options.

Realised capital gains tax for MRPIEs

184. The tax issue is in part a function of the open-ended nature of MRPIEs[86], and in part a function of the tax benefits they provide. The key issue is the need to allocate realised gains and losses to investors not on a simple pro rata basis (that is, pro rata with the value of their investments on the day of realisation). Instead realised gains and losses need to be allocated taking into account the movement in the value of the assets during the period the investor has actually been invested in the MRPIE. We refer to this approach to taxing realised gains or losses on Australasian shares held by a MRPIE as a "partnership approach".

185. Suppose for example that a MRPIE buys an asset at the beginning of June for $1,000. At the beginning of July it is worth $1,300 and at the end of August when it is sold it is worth $1,200 (so the income to be allocated to investors is $200). Suppose also that investors A and B own 1% of the MRPIE at the beginning of June, but at the end of June, B redeems her units for cash, and is replaced by C, who invests an equivalent amount. A owns 1% of the fund throughout the period.

186. In order for the current benefits of the PIE regime to be retained, A and C cannot be allocated an equal share of the $200 gain on realisation of the asset at the end of August. A must be allocated $2, i.e. 1% of the gain. However, C bought into the fund on 30 June, when the asset was worth $1,300. That is, C will have paid $13 for her 1% interest in the asset. It would clearly be wrong for her to be taxed, like A, on $2 of the realised gain. She should have a loss of $1. The balancing figure is B, who should have a taxable gain of $3, which will reflect her economic gain on exiting the MRPIE on the basis that the asset was worth $1,300.

187. Currently this kind of calculation is not required. All of a MRPIE's taxable income is able to be accrued on a daily basis (using either a market value method or FDR) and allocated to investors on a per unit basis during that day. Changes in the value of Australasian shares are accrued, generally on a daily basis, for the purpose of determining the prices at which the fund should issue and redeem units. But there is no need to allocate realised capital gains at all, because those gains are not taxed.

188. In order for a MRPIE to allocate realised capital gain using a partnership approach, it would need to keep a record, for all units issued on a particular day, of the gain or loss arising for each relevant investment held by the PIE on that day. This record would have to be maintained until a unit was redeemed (at which time all the unrealised gain or loss attributable to that unit would be crystallised) or the relevant investment was sold. The gain or loss on sale would be adjusted for any gain or loss already recognised due to redemptions (and, prima facie, subscriptions, as referred to below). The gain or loss so adjusted would be allocated to the units existing on sale in accordance with the amount of accrued gain and loss allocated to them with respect to the investment, which in turn would depend on when the units were issued.

189. The partnership approach also suggests that when a PIE issues units to a new investor, existing unitholders should be treated as selling to that investor a share of their investments, thus triggering a taxable gain or loss for existing unitholders. However, it might be possible to suspend such gain or loss until the investors redeem or the investment is sold by the PIE.

86 That is, they stand ready on a daily basis to issue and redeem their interests. This means that they need to keep a very good track of the value of their portfolios, and also that investors who want to cash out their investments will generally do so by way of redemption rather than sale.

190. The example above is very much simplified. In reality, units are issued and redeemed on a daily basis, and MRPIEs are frequently investing in other MRPIEs. A retail KiwiSaver scheme will often invest in a wholesale PIE that in turn invests in a specialist PIE that invests in actual shares. Applying this partnership approach to determining PIE income would raise significant practical problems and system changes.

191. A further issue is the effect that a realised capital gains tax would have on proceeds available to an investor in a MRPIE on withdrawal of their investment. Currently, MRPIEs generally provide pricing data based on pre-tax redemption proceeds, on the basis that tax is a matter for the investor, and in any event depends on the investor's tax rate. But the discrepancy between pre-tax and post-tax redemption proceeds is relatively small, given that tax is paid on accrued income at least annually. If a tax were imposed on a realisation basis, then for a MRPIE that did not realise shares for long periods, the discrepancy between pre-tax and post-tax investment proceeds could be much greater, which might be difficult for investors to appreciate in advance of redemption.

192. It should be understood that this partnership approach to MRPIE taxation would not involve any additional layer of tax on PIE investment. Only the gains of the MRPIE would be taxed. There would be no further tax on distributions or withdrawals, except, in the case of a withdrawal, to the extent of accrued unrealised gains attributable to the withdrawing investor. This income would be calculated by the MRPIE and attributed to the withdrawing investor along with the attribution of other income earned during the withdrawal period.

193. It might be also be considered desirable to consider the taxation of sales of units in a MRPIE. Currently, sales of units in MRPIEs are rare, and in any event are usually treated by the MRPIE as redemptions by the transferor followed by a fresh issue of shares to the transferee. If a realisation based tax were imposed without any tax on the sale of MRPIE interests, sales might be seen as a way of transferring effective ownership without tax and thus deferring tax. This is the argument for taxing share gains. However, since MRPIEs can distribute gains as excluded (thus untaxed) income it would seem pointless attempting to tax gains. Taxing unimputed MRPIE distributions would be contrary to the objective of those rules – which is to ensure that tax is paid at the fund level. This is an issue still under consideration.

Accrued capital gains tax

194. One way to avoid these difficulties would be for a MRPIE to pay tax on Australasian shares on an accrual basis. This would be consistent with the current systems for calculating the net asset value of the fund, which forms the basis for pricing of unit redemptions and issuances. It would therefore have a relatively low compliance cost. However, it would create a disadvantage for investment through a MRPIE compared to direct investment. Since shares are expected to appreciate in value over time, taxation on accrual is more onerous for the owner than taxation on realisation. The extent of the disadvantage depends on the frequency of trading. The less frequently shares are realised, the more significant the disadvantage of being taxed on an accrual basis.

195. Investment through a MRPIE rather than directly already enjoys the tax advantage of a lower tax rate for most investors. Another potential tax advantage for a MRPIE in paying tax on unrealised gains in Australasian shares is that there would be no need for any loss ringfencing in relation to such shares.

196. If the existing rate differential and removal of ringfencing is not sufficient to counteract the disincentive of accrual taxation on Australasian share gains, a possible way to address this disadvantage would be to reduce the level of inclusion of capital gains from Australasian shares in taxable income. However, the amount of the reduction required to make accrual and realisation based taxes equivalent depends on the level of turnover

and on the MRPIE's nominal interest rate. For example, assuming a tax rate of 28%, a nominal interest rate of 5%, and a fund that realises 20% of its accumulated accrued capital gain each year (reflecting an average 5 year holding period), the appropriate rate of inclusion would be 88%. That is, for each $100 of accrued gain, $88 should be subject to tax. At a 50% realisation rate (reflecting an average two year holding period) the appropriate inclusion rate would be 97% (a shorter holding period means taxing on accrual rather than realisation is less costly and therefore justifies a smaller discount).[87] Adoption of a single discount rate for all capital gains on Australasian shares would give a disproportionately large benefit to funds with high turnover, and a disproportionately small benefit to funds with low turnover. However, it would likely be complex to provide a discount that takes into account a fund's actual trading history, which is likely to change over time.

197. Valuation and liquidity issues are the other reasons for not generally taxing accrued capital gains. Neither would seem to be a problem for these types of PIEs. Their assets are valued, usually on a daily basis, and are easily realisable.

Tax on capital gains as a fund expense

198. A third possible way to deal with this issue would be to provide that the tax on capital gains is a fund level expense. This would be a partial return to the pre-PIE tax system, where investment funds were generally taxed as unit trusts. It would require unit prices to be adjusted to recognise the deferred tax liability. In order for the deferred tax liability to be calculated, the tax would have to be imposed at a single rate. A mechanism would then have to be found to adjust this rate to the investor's marginal rate. Otherwise it would have to be accepted as a derogation from one of the objectives of the PIE regime. The Group does not see this as a promising option

Tax Australasian shares on a FDR or similar basis

199. A fourth option would be to tax Australasian shares on an FDR or similar basis. This would be administratively workable, just as the FDR regime is workable. However, for New Zealand shares it would need to be integrated with the imputation system and would again create a significant distinction between direct and managed investment (assuming direct investment in Australasian shares is not taxed on an FDR basis).

Continue with current exclusion

200. The last option is to continue with the current exclusion for gains from Australasian shares. This is the simplest option but would obviously mean that MRPIEs would have a significant tax advantage (no tax on share gains) over direct shareholding or investing via other entities, which would be taxed under the new rules.

201. The Group intends to engage in further consultation with the industry on the above options.

Property MRPIEs

202. Some MRPIEs invest in unlisted real property, either directly or through a special purpose company. Because this investment is illiquid, such funds are generally closed, and do not offer redemption facilities. Investors wanting to realise their investment before the fund winds up have to do so by selling their units to another buyer. Accordingly, there is less need for daily valuations or allocations of income. Valuations are typically produced once a month, quarter or year. Allocations of income are on a similar basis. Even though income will accrue on a daily basis, all income for the relevant period (month, quarter or year) will accrue to the investors of record on the allocation date.

203. Property MRPIEs will generally carry a deferred tax balance in their accounts reflecting the difference between the accounting and tax book value of fit out.

87 The inclusion rate is slightly lower as the tax rate decreases, but the difference is small. For example at a 17.5% rate, the inclusion rate is 86% and 96%.

204. Taxing Property MRPIEs on an accrual basis seems much more problematic than for open ended MRPIEs. Their assets are illiquid and more difficult to value. The imposition of tax on a realisation basis also seems less problematic, in that such investments are generally longer term ones from the perspective of the investor. Accordingly, it may be preferable for Property MRPIEs to pay tax on a realisation basis, and to allocate this tax to investors of record on the date the realisation occurs.

205. However, taxation on this basis raises a number of issues in relation to sales of interests in Property MRPIEs. In particular:

- if sales of MRPIE interests are not taxable, then it would be possible for the tax on sale of a Property MRPIE's assets to be eliminated by ensuring that all of the interests in the MRPIE are acquired by a tax exempt investor, such as a charity, shortly before the sale;
- it may be difficult for a MRPIE to calculate its deferred tax liability, since the rate of tax on sale would depend on the tax rate of investors at the time of sale (though if the MRPIE holds its properties in a company rather than directly, the prima facie deferred tax liability might be on the basis of the ordinary corporate tax rate).

206. The Group intends to engage in further consultation on this issue.

Listed PIEs

207. The amount invested in listed PIEs is much smaller than that invested in MRPIEs. Listed PIEs are not vehicles for KiwiSaver investment. Nevertheless, they are a material part of our capital market.

208. Listed PIEs are generally taxed as companies. Investors do not pay tax on an attribution basis, but on dividends, with imputation credits able to be attached in the usual way. The difference between taxation of a Listed PIE and taxation of an ordinary company is that:

- a Listed PIE is tax exempt on gains from sale of Australasian shares;
- dividends paid by a Listed PIE are:
  - required to be imputed to the extent the company has credits to do so;
  - excluded income to the extent they are not imputed;
  - able to be excluded from income at the election of the shareholder to the extent that they are imputed.

209. These rules mean investors in a Listed PIE are taxed in a similar way to investors in a MRPIE (though the tax rates for lower marginal rate investors will usually be higher than their portfolio investor rates). However, the investors' liquidity is provided by trading on the market rather than by redemptions.

210. From a practical perspective, because Listed PIEs do not have to attribute income to their investors, it should be possible for them to pay tax on gains on a realisation basis.

211. Under the new rules, distributions by a Listed PIE can continue to be treated as they are at present:

- Unimputed dividends should continue not to be taxable, though for PIEs holding Australasian shares or real property investments, the amount of unimputed dividends will be reduced, since the Listed PIE's gains will generally be taxable (as for other companies, gains accrued before the extension of the tax will remain exempt). Gains on shares taxed under the FDR regime in excess of the 5% rate would continue to be tax exempt, and therefore would give rise to unimputed dividends when distributed.

- Imputed dividends should continue to be able to be excluded from income at the election of the investor, so as to ensure the tax rate on the investments does not exceed 28%.

212. Gains from sale of shares in a Listed PIE should prima facie be subject to tax. However, as with MRPIEs listed PIEs can distribute any gain to investors as excluded untaxed income – by way of issuing new shares. If listed PIEs were not able to distribute unimputed income as excluded income but MRPIEs were, there would seem to be a clear incentive for listed PIEs to reform as MRPIEs and establish a market for investors to sell units just as some property MRPIEs already do. Again this is still under consideration but the Group has a concern if individuals owning shares will be taxed on gains but investors in closely substitutable entities are not. This is for the same reason that sales of shares in any other company should be subject to tax. If the sale is not taxable, investment in a Listed PIE can be used as way for shareholders to dispose of otherwise taxable assets without having to pay tax. While the sale price will be discounted for the Listed PIE's deferred tax liability, this discount does not result in any actual tax revenue, and will generally be less than the amount of tax otherwise payable (because it is deferred). Furthermore, tax-free disposals could be used as a way to transfer income from higher rate taxpayers to lower rate ones. These issues are all still being considered.

Other Entities

213. Life Offices are another entity where policyholders are not taxed on unimputed distributions of income. It follows that it might not be appropriate to tax policyholders on gains in their policies at the policyholder level. That is, it might not be appropriate to tax these investors in a manner similar to shareholders – once at the entity level and again at the shareholder level.

214. Māori authority distributions are taxable only when the distribution is out of income of the Māori authority. A distribution of accrued gains (even if taxable on realisation) would not it seems be a distribution of income so that again it might not be appropriate to tax members on gains in selling any interest in a Māori authority. This issue may have little or no practical significance, since interests in Māori authorities are generally not able to be sold.

XVII Taxation of corporate groups

215. Sales of shares of group companies raise particular double tax and double deduction issues especially if income or loss can be attributed from a company to another group member, and the attributing company is later sold. For example, a group company could incur a loss and have the loss transferred to another group company, which allows the other group company to enjoy the loss through attribution. The loss company, whose shares will have fallen in value as a result of incurring the loss, could be sold and the selling company thereby would realise a capital loss.[88] This would allow the same economic loss to effectively be deducted twice within the group. Similar issues arise with attribution in the consolidation regime and also through extracting value with exempt intra-group dividends. Possible double deduction issues for companies outside of the company group context were discussed in paragraph 160 and 163.

216. An example of why adjustments are necessary in loss attribution scenarios:

- Suppose a member of a company group incurred a tax loss. It could deduct this loss itself, but the benefit of the tax deduction would be confined to that company. The company would be likely to fall in value as a result of incurring the loss. The parent company could sell the shares of the company and realise a loss from selling its

88 An example is *AMP Life Ltd v CIR* (2000) 19 NZTC 15,940.

shares, but this is the only time the parent would have a tax benefit from the loss it suffered through owning the subsidiary that lost income.

- Suppose instead the loss company transferred the loss to the parent. The parent could deduct the transferred loss. The loss company's shares would also have fallen in value as a result of incurring the loss. If the parent sold those shares for a loss, the parent company would be allowed a deduction for that, in addition to the loss it deducted when the loss was transferred to it. The parent would have claimed the same economic loss twice.
- In order prevent this, the cost base of the shares of the loss company should be reduced by the amount of the loss transferred. This reduces the capital loss to be incurred on the sale by the same amount, preventing the double loss deduction for the parent.
- Consequential adjustments would also be required to the cost base of the shares of the company which benefits from having the loss transferred to it. This is explained in the discussion below.

217. Some countries have considered these issues and have adopted share cost base adjustment rules which manage them. The following describes the rules the Group considers might be required under the new rules in the company group context.

Cost base of shares – general rules

218. Before discussing the adjustments, it is useful to recap the general rules for determining the cost base of shares for any shareholder of a company. This does not consider details of cost base rollover adjustments as a result of rolling over income or loss.

- **Acquisition cost** – the starting point for the shareholder's cost base in shares is the cost of acquiring them. If they are purchased from another shareholder, it is the purchase price. If the shares are acquired upon incorporation of a new company, it is the amount contributed to the company in exchange for the initial issue of shares. If a new company is incorporated and property (other than cash) is contributed, then rollover rules could potentially apply which means the company shares' cost base would be the cost base of the transferred property rather than the market value of the transferred property.
- **Capital contribution** – If an existing shareholder makes additional capital contributions with respect to shares it already owns (as opposed to having new shares issued), then the cost base of the shares is increased by the amount of additional capital contributed to the company (again, if property is contributed, rollover could potentially apply).
- **Company distributions** – Although a distribution from a company with respect to its shares (such as by a dividend) is a transfer of value from the company to the shareholder, the general rule is not to adjust the cost base of shares for the distribution. If the distribution is an imputed dividend, then no adjustment should be made because the distribution is of income that has already been taxed. If the cost base of the shares were reduced, then there could potentially be double tax when the shares are later sold. If the distribution is an unimputed dividend, then the dividend itself is usually taxable, so there is no need to reduce the cost base of the shares. A special rule for an unimputed dividend that is not taxable because of the intercorporate dividend exemption is discussed below. If a distribution is by way of a share buyback with some shares cancelled, then the distribution results in a realised gain or loss on disposal of those shares, with the cost base of the remaining shares unchanged. If the distribution is made in liquidation of a company, then there would be a realised gain or loss on disposal of the shares (although if the shareholder is a company that owns all of the shares of the liquidated company, then rollover may apply).

Elective group loss transfers

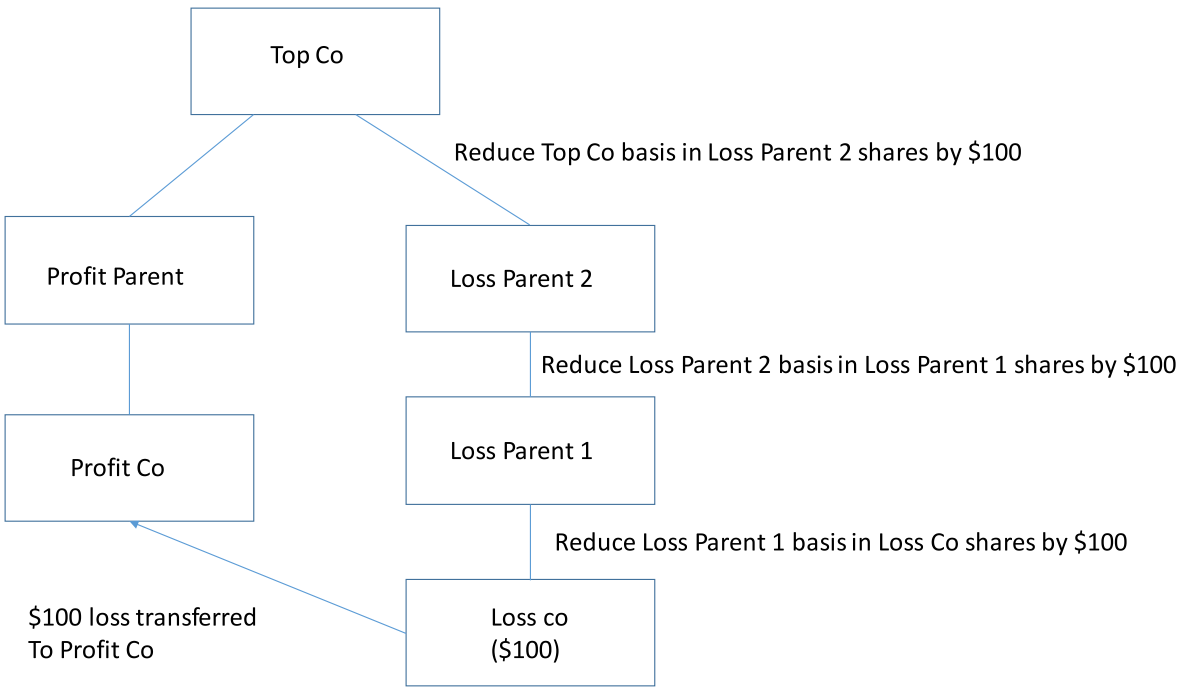
219. If two or more companies are members of the same at-least 66% commonly-owned group, then a loss of one company may be transferred to another company in the group. This may be done simply by electing and reporting the transfer in self-assessment, or by having the loss-receiving company pay the loss-transferring company a payment equal to the amount of the loss (a subvention payment). The subvention payment is deductible/assessable.

Group loss offset – no subvention payment

220. Take the case where a loss offset is affected without a subvention payment. If no adjustment is made, then a grouped loss has the potential to be deducted twice. For example, in the *AMP Life Ltd v CIR (2000) 19 NZTC 15,940* case referred to above, a group company whose shares were held on revenue account incurred a loss which was transferred to its parent company. The shares in the group company were later sold for a loss. This resulted in the same economic loss to effectively being deducted twice.

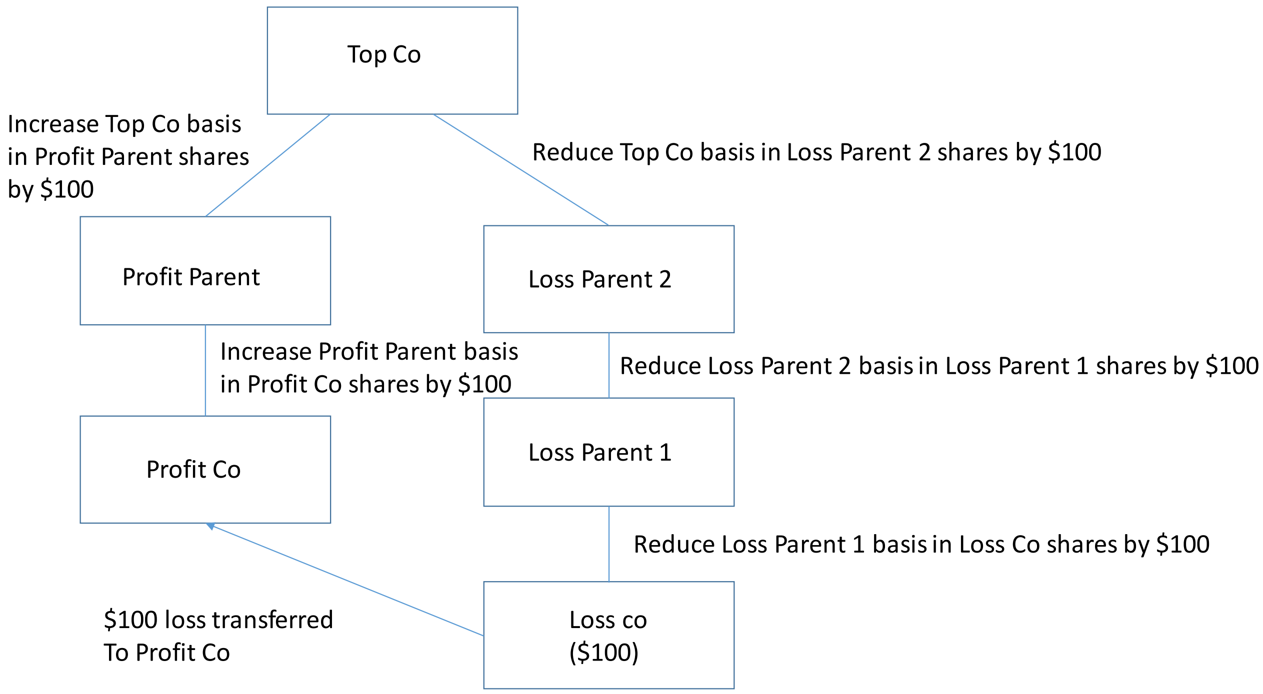
221. In order to prevent this the Group proposes that the cost base of the shares of the company transferring the loss must be reduced by the amount of the loss transferred. This means a capital loss from selling the shares is reduced by the same amount as the loss transferred.

222. Suppose the company that transferred the loss is two levels down from the company that sells the shares (of the loss company's parent). There is still a double loss potential unless the cost base of the parent company's shares is also reduced. This means a cost base reduction for the amount of the transferred loss must be mirrored up a chain of companies.



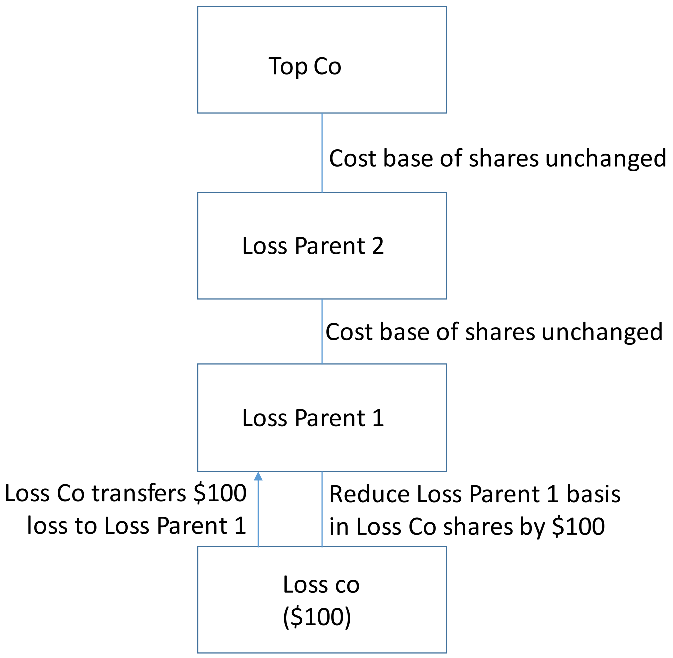
223. Although the cost base of the loss transferring company's shares are reduced, the total cost of the group shares as a whole should not change, as the shareholders (collectively) still paid a certain amount for the group company shares (collectively). In order to reflect this, the company receiving the benefit of the transferred loss should have the cost base of its shares increased by the amount of the loss it receives. It obtains the benefit of having tax on its profit offset by the transferred loss, which is the intended policy outcome. This benefit increases the value of the company. Unless an adjustment is made to the cost base of its shares by increasing it for the loss received, this benefit would be undone by capital gain on selling its shares. In order to prevent this, the cost base of the shares should be increased by the amount of the loss it receives. As with the loss company, the increase in the cost base of the shares should be mirrored up a chain of companies.

224. Suppose a loss is transferred from a subsidiary to its parent. The cost base of the shares of the subsidiary should be reduced by the amount of the loss transferred. Under the mirroring provision, the cost base of the shares of the parent should also be reduced by the amount of the loss transferred. But under the rule for receiving the transferred loss, the cost base of the shares of the parent should be increased by the amount of the loss. In effect, these two adjustments cancel each other out, and the cost base of the shares of the parent remains unchanged. This is the right outcome as, from the perspective of the shareholder of the parent, its cost in the two-company group is the same and the sharing of loss between the two companies does not affect the cost of the shares of the parents of the two-company group.



Other provisions

- *Loss exceeds cost base of shares* – we do not propose that the cost base of shares could ever be negative. Therefore, the negative adjustment to the cost of the base of the shares of the loss company would be the lesser of the loss amount and the cost base of the shares (before the adjustment).[89] Since the adjustment to prevent the double deduction could not then be fully made, we also proposed that the adjustment for the company receiving the loss be the amount of the loss company's adjustment, even if it less than the amount of the loss transferred. As the loss adjustment is mirrored up a chain of companies, no company's shares cost base could be less than zero (although, if this limit applies to reduce a parent company's adjustment by more than the loss company's adjustment, we do not propose any additional change to the loss-receiving company's adjustment).
- *Minority interests* – the loss transfer provisions require at least 66% common shareholding, so it is possible that there could be minority shareholders in the loss or profit company. As minority shareholders generally will not benefit from the loss transfer, no adjustment should be made for shares they own in the loss company. An adjustment should be made only for shares held by a company that is in a group with at least 66% common ownership with both the loss company and the company receiving the loss transfer. If an adjustment is made for less than 100% of the loss company shares, an adjustment for the full amount of the loss transferred must be made for those shares that are able to be adjusted.



89 There is an argument that the excess of the transferred loss over the cost base of the shares should be treated as income, however, we are not proposing this.

- *Timing of adjustments* – Elective loss transfers are usually decided after the end of the income year, when tax returns are filed. So there could be some logic to having the adjustment effective as of the last day of the income year. However, because the loss transfer affects the tax position of the companies during the income year, and the potential of double loss could arise if the loss company is sold during the same income year, we proposed that if a relevant company is sold during the year, an adjustment must be made immediately before the sale.

Group loss offset – subvention payment

225. If a group loss offset is given effect by a subvention payment – then the treatment is much simpler. No share cost base adjustments would be necessary.

226. The loss company would receive a payment from the profit company in order to absorb the loss. This will transfer value to the company so the loss no longer represents in inherent loss in the value of the shares. The same will apply for the profit company. The profit company obtains the benefit of the loss offsetting tax on its profit, but the company's value is reduced by the amount of the payment, so there is no need to increase the cost base of shares in order to prevent double tax.

Consolidated groups

227. Companies that are members of a New Zealand consolidated group must still determine their own taxable income.[90] The taxable income of each group member is combined (subject to some adjustments) and tax for the group is paid by the nominated company.

228. Each member of the consolidated group can be viewed as contributing their income and loss to the group as a whole on a current basis. This raises the possibility of double deductions or double tax if a group member is sold unless automatic adjustments are made. This is an issue already, but currently it is unlikely that shares in a consolidated group member would be held on revenue account.[91] The United States has comprehensive rules for making adjustments to the cost base of shares in consolidated group companies.[92] We are proposing adopting rules such as these but much simpler.

229. For each year, the cost base for shares in each consolidated group member would be:
    - the opening cost base; plus
    - contributions to capital made during the year; plus
    - taxable income of the group member as determined under section FM 3(2) (if positive); less
    - distributions of the consolidated group member made during the year; less
    - tax loss of the group member as determined under section FM 3(2) (if negative).

230. As with the elective loss transfer, for chains of companies, adjustments to the share cost base of lower-tier companies should be mirrored up a chain of companies. Also, share cost bases should not be reduced below zero.

231. Adjustments should be made at the end of the income year, but if a relevant company is sold during the income year, the adjustment should be made with effect immediately before the sale.

232. Further consideration needs to be given to the treatment of intra-group transactions, which are ignored when determining a member company's taxable income position, to ensure no unintended consequences arise.

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90 See section FM 3 Income Tax Act 2007.

91 The Income Tax Act currently has an anti-avoidance rule if shares in a consolidated group member are held on revenue account and they are sold for a loss after manipulations to reduce the value of the shares. See sections CV 3 and FM 23.

92 Treas.Reg. section 1.1502-32.

Corporate groups – exempt intercorporate dividend

233. A last category for an automatic adjustment is for payment of a dividend from a wholly-owned group member.

234. As mentioned earlier, generally no adjustment would be required for receipt of an imputed dividend (as that is usually a distribution of taxed income) or for receipt of an unimputed dividend (since the dividend is usually taxed). However, we propose that the cost base of shares in a wholly-owned subsidiary should be reduced by the amount of a dividend paid by the wholly-owned subsidiary, unless:

    - The dividend is imputed, and the shareholder and the company are not members of the same imputation group of companies; or
    - The dividend is paid by a member of the same imputation group of companies, and the dividend was paid out of income that was taxable income of the company paying the dividend; it is appreciated that there will be practical difficulties in applying this rule and it is still being considered.

235. The last point reflects the fact that an imputation group allows easy transfers of credits within the group, so payment of an imputed dividend is not, in itself, sufficient to establish that it was paid out of taxed income of the company. The reason for this rule can be shown by a simple example:

    - Parent Co owns Sub Co. The cost of the Sub Co shares is $100 and Sub Co has assets worth $100.
    - Buyer wants to buy all the shares of Sub Co. It is willing to pay Parent Co $100 for the shares.
    - Instead, Parent and Buyer agree to the following:
        - Buyer lends Sub Co $90;
        - Sub Co pays a $90 dividend to Parent Co (reducing the value of Sub Co shares from $100 to $10) (the dividend is exempt under section CW 10);
        - Buyer pays $5 to Parent Co for all of the shares of Sub Co (generating a $95 capital loss for Parent Co but only a $5 economic loss, which is amply compensated for by the tax benefit);
        - Buyer owns all of the shares of Sub Co. It capitalises the loan and has the shares with a cost base of $95.

236. Although such an extreme transaction could be challenged, it serves to illustrate the general issue which could be addressed with an adjustment for the cost base of the shares for the payment of an exempt dividend in some cases.

XVIII Livestock and other assets

237. An essential part of the detailed design of the rules for extending the taxation of capital gains will be integration with existing regimes. The integration will depend on the more material design issues referred to in this Appendix. For example, the bloodstock tax regime might be unaffected as bloodstock are already either held on revenue account (taxable) or exempt from tax, depending on the activities of the owner.

238. Farmers can apply various regimes for valuing livestock for tax purposes, including national standard costs or by applying the herd scheme. National standard cost in effect treats livestock as trading stock of the farmer. Because national standard cost livestock is explicitly on revenue account the rules extending the taxation of capital gains would not apply.

239. However, under the herd scheme livestock is valued each year at the national average market value. Changes in national average market value from year to year are treated as being on capital account and not subject to tax. The Group understand that a significant number of farmers use the herd scheme to value all or most of their livestock. Careful consideration of the issues associated with herd scheme livestock and the proposed rules will be necessary.

XIX Administrative aspects

240. Because the rules taxing realised capital gains do not impose a new tax, no changes to the existing machinery for returning income and paying tax seem obviously necessary. Nevertheless, the degree to which these rules will impact on Inland Revenue should not be under-estimated. Many taxpayers who have not previously needed to interact with Inland Revenue are likely to be required to do so. For example, a wage or salary earner with just PAYE income and interest income with a holiday home need not file tax returns at present. Under the rules they would need to do so when their holiday home is sold. Overseas experience suggests that taxation of property gains in particular proves to be a technically difficult and contentious area of tax law, especially if the rules have wide roll-over relief and loss ring-fencing. Many family trusts do not prepare financial statements or file tax returns. Whilst an excluded home remains outside the proposed rules, most other assets (share investments, holiday homes) will need to have their cost base and capital improvements recorded (to be deducted against any sale of the property that might realise capital gains). When a person emigrates from New Zealand, a deemed disposal of their New Zealand assets could produce taxable gains and final tax liabilities.

241. Under proposals contained in the recently introduced Taxation (Annual Rates for 2018-19, Modernising Tax Administration, and Remedial Matters) Bill, Inland Revenue will automatically assess an individual's tax refund or tax to pay where it judges that the income information which it has received for the person from third parties such as employers and banks throughout the year (reportable income), represents all income for the period.

242. Because any taxpayer may have made a capital gain in any tax year, the number of cases in which Inland Revenue would be confident to automatically assess based on reportable income would reduce, unless there was some in-year reporting of gain information. Even then, it would not be possible for the Commissioner to complete their assessment since capital gain income is highly likely to have expenses deductions. Inland Revenue will need the systems and resources to administer what will be a material expansion of the income tax administration, both in terms of funding, and technically skilled staff and audit capability.

243. The Group's preliminary views on certain compliance issues are as follows:

- Withholding taxes. These seem especially relevant to individuals, who might otherwise not be required to file a tax return. It may be sensible to impose tax on gains on sale on a withholding basis, where the tax is paid either by the vendor or the purchaser. Withholding tax is already part of the brightline provisions, where land is sold by a non-resident. Imposing a withholding tax could improve collections but might not necessarily reduce compliance costs (higher costs for the payer required to make the withholding payment and individuals would still require a "wash up" calculation in an annual tax return). Setting a withholding rate would be problematic as net gains are taxed and withholding taxes ordinarily apply to gross payments. It is also not clear to what extent withholding taxes could be relied upon. A further difficulty is that withholding obligations should not be imposed on shares if that would be likely to reduce the liquidity of capital markets.
- The effect on provisional tax obligations. It might not be sensible for a person who derives a large gain from a one-off sale to thereby be put into the provisional tax regime, with consequences not only for the year of the sale, but for the next year too. It is possible that current provisional tax rules should apply given that taxpayers already have the option of estimating at the third provisional tax date. We note that owners of revenue account property can already face late changes in provisional tax liabilities and the new rules would not change this.

- Information obligations. Given the amount of time that may pass between a cost being incurred to acquire or improve a capital asset and that cost being deductible (i.e. when the asset is sold), in the Group's view it may be desirable for some kind of contemporaneous documentation to be required to be filed with Inland Revenue on an annual basis, itemising the cost of the assets subject to the rules, in order to ease compliance at the time of sale. It need not be the case that this documentation creates any kind of obligation on the Commissioner to confirm it until the time when the relevant asset is sold. The Commissioner would also have ready access to the cost information should an audit be required.

XX Other Issues

244. There are a number of other issues largely relating to how the new rules would integrate with existing tax rules. These include:

- existing rules for taxing revenue account property (including their holding costs);
- finance lease and share swap rules;
- bad debt rules restricting deductions if not in the business of lending or trading and if to an associated person;
- share cancellation and repurchase and Treasury stock rules;
- share for share exchanges and share lending;
- amalgamation of companies;
- employee share schemes and options.

245. We expect that there will also be other issues that will arise as a result of industry and stakeholder consultation and of course through the Generic Tax Policy Process.

Appendix C: Secretariat advice

In the course of its consideration of the issues discussed in this report, the Group received advice papers from its Secretariat - a cross agency group of officials mainly from the Treasury and Inland Revenue. A full list of that advice follows. Each paper can be found on the Tax Working Group's website.

Introductory/frameworks

- An Introduction to Frameworks for Evaluating Tax Reform
- Tax Working Group Assessment Framework
- Tax and Fairness

Extending the taxation of capital income

- Extending the Taxation of Capital Income
- Potential high-level effects of proposals to extend the taxation of capital income
- Distributional analysis and incidence
- RFRM and Land Taxes
- Taxation of capital income and wealth
- Secretariat support papers on various CGT design issues
  - Rollover relief
  - Transition, valuation day, and the median rule
  - Inflation and capital gains

Housing

- Tax and Housing
- Tax and Housing II
- Residential property compliance work

Environment

- Tax and the environment – Paper I: Frameworks
- Tax and the environment – Paper II: Assessments
- Environmental tax concessions raised by submitters
- Environment tax frameworks – finding of external reviewers

Business tax

- Business tax - summary
- Appendix 1: Types of business entities in New Zealand and how they are taxed
- Appendix 2: Company tax rate issues
- Appendix 3: New Zealand's imputation system
- Appendix 4: Closely-held companies
- Appendix 5: Dividend avoidance
- Appendix 6: Measures to improve efficiency
- Appendix 7: Lower tax rates for small companies
- Company tax rate issues – further information
- Further information on Marginal Effective Tax Rates
- Effective company tax rates
- Company tax rate issues – review of Secretariat modelling
- Taxing international Business Income
- Update on taxing the digital economy
- Effective company tax rates in New Zealand

GST

- Background Paper: GST
- GST and Low-Value Imported Goods
- Note on effect of decreasing the rate of GST
- Incidence of GST exemptions
- Taxing financial services

Integrity

- Trusts
- Closely-held Companies Follow up
- Preparing the tax system for the future
- Tax policy report: Estimating the under-reporting of income in the self-employed sector (IRD policy report on self-employed compliance)
- Hidden Economy
- Dependent contractors
- The Future of Work
- Future of work: Sustaining the tax system
- Charities and the not-for-profit sector

Tax administration

- Collection of tax debt
- The Generic Tax Policy Process
- Tax transparency

Māori issues

- Tikanga Framework (Draft)
- Māori authorities

Revenue-negative options

- Potential revenue-reducing options
- Appendix A: Productivity
- Appendix B: Changes to tax rates and thresholds
- Appendix C: Depreciation on Buildings
- Appendix D: Changes to loss continuity rules
- Appendix E: Inflation indexing the tax system
- Appendix F: Compliance cost reductions
- Appendix G: Depreciation and investment incentives
- Appendix H: Reducing taxes on future generations
- Appendix I: Changes contingent on a capital gains tax

Other

- Summary of submission from individuals
- Submissions from organisations and academics
- Financial Transaction Taxes
- Tax and gender
- Corrective taxes
- Taxation of Retirement Savings
- Government reviews that could impact the Tax Working Group
- Distributional analysis

Note on Secretariat modelling estimates

The Secretariat has produced projections of revenue for policies considered in this report. These projections rely on modelling assumptions and are subject to uncertainty. All estimates are preliminary and presented for indicative purposes only.

All estimates using Household Economic Survey (HES) data should be considered indicative and may have wide confidence intervals. Sample survey data is subject to sampling and non-sampling errors. These estimates have been produced either directly from HES or using the Treasury's micro-simulation model of the tax and welfare system. Estimates rely on modelling assumptions and are subject to considerable uncertainty. The 1988 Jensen equivalence scale has been used for equivalizing household incomes. In some cases, the officials' secretariat has made adjustments to reflect underreporting of household expenditure in survey data compared with the national accounts aggregates. Owing to data limitations, such adjustments are approximate and may not accurately reflect differences across expenditure categories or income deciles. In some cases, there are differences between charts and estimates in the Interim Report and earlier officials' papers owing to data updates and modelling changes. All estimates are subject to further data updates and modelling refinements. Access to HES data was provided by Statistics New Zealand under conditions designed to give effect to the security and confidentiality provisions of the Statistics Act 1975.

Glossary

Accommodation supplement: A non-taxable benefit payment that provides cash assistance for a person's accommodation costs in the private market (both owners and renters).

Aggregate national income/gross domestic product (GDP): The total value of goods and services produced in the economy in a year.

Base erosion and profit shifting (BEPS): Strategies used by multinational companies to minimise their worldwide tax liability. The OECD has led work to counter these strategies with recommendations for upgraded international tax rules.

Beneficiary income: For a trust, beneficiary income is income of the trust that is allocated to a beneficiary and is taxed in their hands. (See also: trustee income.)

Black hole expenditure: Business expenditure of a capital nature that is not deductible for tax purposes and does not give rise to a depreciable asset, so cannot be deducted as tax depreciation over time.

Bracket creep: The effect created when inflation increases a person's average tax rate because more of their income is taxed in higher tax brackets. (See also: inflation.)

Bright-line test: A rule that taxes gains on residential properties (that are not owner-occupied) that are bought and sold within five years.

Broad-based, low rate (BBLR): A tax policy framework under which taxes apply to a wide range of income or consumption with few or no gaps or exemptions, allowing substantial revenue to be raised at relatively low rates of taxation.

Building depreciation deduction: A deduction for the depreciation of buildings. (See also: deduction, depreciation.) New Zealand has not allowed these deductions since a law change in 2010.

Capital income: Income that is a return on invested capital (that is, income from owning something rather than from personal effort) such as interest, dividends, rental income, gains on the sale of capital assets, and the return on capital invested in a business. (See also: labour income.)

Carbon tax: A tax imposed on the burning of carbon-based fuels.

Closely-held business/company: Businesses that are owned by a small number of shareholders.

Controlled foreign company (CFC): Non-resident companies that are controlled by New Zealand shareholders. New Zealand has a regime (the CFC regime) to tax the income of such companies in some circumstances.

Cost of capital: In economics, cost of capital is the rate of return that investors require to contribute capital to a particular project.

Current account: An accounting term which means the balance of the amounts (other than capital) lent by a shareholder to a company and borrowed by the shareholder from the company.

De minimis: In tax, a rule with a de minimis would exempt amounts under a certain threshold from the general application of the rule.

Deadweight loss: In the tax context, this is the cost to society due to individuals, households, and firms making consumption and production choices in order to pay less tax, in the case where the tax is not intended to change behaviour deliberately.

Deduction: An amount subtracted from gross income as an allowable expense.

Departure prohibition order: A tax administration measure that can restrict a person from leaving the country due to unsatisfied tax or other regulatory obligations.

Depreciation: The expected reduction in the value of an asset over time.

Digital economy: The part of the global economy that is based around the use of digital information.

Dividend stripping: A form of tax avoidance that converts a taxable dividend into a non-taxable capital gain in the hands of a shareholder.

Donee organisation: A status for an organisation that means its donors can claim a tax credit for their donation.

Double tax agreement: A treaty between tax jurisdictions on how cross-border income will be taxed in each country, and to facilitate exchange of information and other forms of cooperation between tax administrations to assist with tax compliance.

Economic rents: The return on an investment greater than that needed for the investment to be viable.

Effective tax rate: The rate at which real, pre-tax profits or income is taxed.

Elasticity (of demand and supply): In economics, elasticity measures the responsiveness of demand or supply to a change in price.

Employer's superannuation contribution tax (ESCT): The tax on employer contributions to an employee's superannuation scheme (such as KiwiSaver).

Equalisation tax: A tax targeted at the digital economy separate to the corporate income tax.

Ex ante: Based on forecasts rather than actual results.

Excise: A tax on the sale of a specific good. Excise taxes are indirect taxes, which means that the tax is levied on the producer of the good rather than the consumer, and the amount of the tax is generally included in the price charged for the good.

External debt: The amount of debt (public and private) owed by a country to overseas creditors.

Externality: A consequence of an economic activity or transaction experienced by unrelated third parties.

Fair dividend rate (FDR): Method of taxing foreign shares held as a passive investment. Income is deemed to be 5% of the opening market value of shares, and tax is paid on this amount.

Financial arrangements: In tax, most financial instruments other than shares are considered financial arrangements. New Zealand taxes parties to financial arrangements on an accruals basis over the life of the arrangement instead of when payments are actually made.

Financial/physical capital: This includes things like houses, roads, buildings, hospitals, factories, equipment and vehicles. These are the things which make up the country's physical and financial assets which have a direct role in supporting incomes and material living conditions.

Financial transaction tax: A tax on the purchase, sale, or transfer of financial instruments.

Foreign direct investment: Overseas investment into New Zealand that is more substantial than passive investment. A New Zealand subsidiary of a foreign parent company is an example of foreign direct investment.

Foreign investment fund (FIF) regime: Rules for taxing New Zealanders on their foreign shares held as a passive investment. (See also: Fair dividend rate (FDR), which is part of the FIF regime.)

Free allocation: In relation to an emissions trading scheme, free allocation is a position of unrestricted trading of carbon credits.

Fringe benefit tax: A tax on most non-cash benefits provided by employers to employees.

General anti-avoidance rule (GAAR): A rule that counters tax avoidance arrangements by overriding other tax rules to deny the tax benefits of an arrangement when a more than incidental purpose of the arrangement is to obtain a tax benefit.

Generic Tax Policy Process: The New Zealand government's approach to developing tax policy. It has been used since 1994 and prioritises consultation.

Gig economy: The trend in workers having temporary jobs, less regularity in their working conditions and operating as independent contractors, in part due to technological developments.

Goods and services tax (GST): A broad-based tax on consumption in New Zealand.

Goodwill: An intangible asset of a business recognised upon acquisition. Goodwill can include the value of brand, customer base, and reputation.

Hidden economy: Economic activity that is not declared and goes untaxed.

Horizontal equity: The principle that people with similar income and assets should pay the same amount in taxes. (See also: Vertical equity.)

Human capital: This encompasses people's skills, knowledge and physical and mental health. These are the things which enable people to participate fully in work, study, recreation and in society more broadly.

Imputation regime: Regime that integrates company tax with personal income tax for residents, ensuring that residents are not double-taxed on their income from companies.

Imputed income: A person can be said to receive imputed income if they provide a service to themselves instead of dealing with another person. For example a person that owns a house can provide shelter for themselves without having to pay rent to a landlord. This benefit is imputed income of the person.

Income decile: A statistical term describing a 10% segment of a population that has been sorted according to its income. Decile 1 refers to the 10% of households with the lowest incomes and decile 10 refers to the 10% of households with the highest incomes.

Indexation: The adjustment of an amount (for example a tax liability or threshold) according to changes to the cost of living. (See also: bracket creep, inflation.)

Inflation: Inflation occurs when the prices for goods and services generally increase in an economy.

Input tax deductions: A GST-registered person can claim an input tax deduction for the amount of GST they paid on a good or service if it is to be used by them to make a further supply of a good or service that is subject to GST. For example a retail shop that purchases goods wholesale can claim back GST on the wholesale price as an input tax deduction.

Kaitiakitanga: A Māori concept encompassing stewardship.

Labour force participation: The proportion of working-age population that are employed or are seeking to be employed.

Labour income: Income from personal effort, including salaries and wages (as well as the returns from the owner of a closely held business working in that business). (See also: capital income.)

Land: In this report, land generally means both the unimproved land as well as improvements made on the land, such as housing. However, when referring to a land tax, it means solely the unimproved value of land.

Land-banking: The practice of buying land with no immediate plans for development.

Land tax: A tax on the *unimproved* value of land.

Lease inducement payment: An unconditional lump sum cash payment made by a person (usually a landlord) to induce another person to enter into a lease.

Lease surrender payment: A payment made by a person to their landlord or tenant in exchange for the surrender of a lease.

Living standards framework: An approach developed by the Treasury, based on four capitals (human, social, natural, and financial and physical), for analysing living standards and intergenerational wellbeing.[93]

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93 More information can be found here: http://www.treasury.govt.nz/abouttreasury/higherlivingstandards

Look-through company: A type of closely-held company in which the owners are jointly attributed with the income and expenditure of the company for tax purposes.

Loss continuity rules: Rules based on continuity of shareholding that restrict when losses can be carried forward and offset against income in future years.

Loss ring-fencing: A tax rule whereby a particular type of loss can only be offset against a particular type of income (usually of a similar character).

Low value write off threshold: The maximum total value of an asset that can be immediately deducted on purchase. Assets with a higher value must be depreciated over their useful life for tax purposes. The threshold is currently $500.

Manaakitanga: A Māori concept encompassing care and respect.

Māori authority: A Māori ownership structure under New Zealand law that is taxed at a rate of 17.5%.

Marginal effective tax rate (METR): A theoretical measure of the tax rate on real, pre-tax income for investments that only just make economic sense.

Marginal tax rate: The rate of tax applied to the next dollar of income earnt.

Mātauranga Māori: Refers to Māori systems of knowledge, understanding, and wisdom.

Member tax credit: A contribution by the New Zealand Government to KiwiSaver members.

National saving: A country's total amount of savings, consisting of private savings and the Government's savings.

Natural capital: All aspects of the natural environment needed to support life and human activity. It includes land, soil, water, plants and animals, as well as minerals and energy resources.

Ngā Whenua Rāhui: A Crown initiative that enables Māori land owners to partner with the Crown (through a covenant) to promote the protection of indigenous ecosystems on Māori land. The initiative is supported by a contestable fund and serviced by the Department of Conservation.

Nominal income: Nominal income is income before accounting for the effect of inflation. (See also: real return.)

Ohanga: A Māori concept encompassing prosperity.

Passive income: Income of a person sourced from activity that the person is not actively involved in. Interest, dividends and rent are examples of passive income.

Payroll tax: Tax paid by employers, employees or the self-employed, either as a proportion of payroll or as a fixed amount per person, and that do not provide entitlements to social benefits.

Pay as you earn (PAYE): A tax collection regime that requires employers to withhold tax on wage and salary income as it is earned and send it to Inland Revenue on behalf of employees.

Permanent establishment (PE): A physical presence of a non-resident taxpayer in a country that gives rise to tax obligations.

Portfolio investment entity (PIE) rules: The PIE tax rules apply to collective investment vehicle where investors combine resources to make investments. PIEs pay tax on investment income based on the prescribed investor rates of their individual investors. The prescribed investor rate is a final rate and is capped at 28%. There is no additional layer of tax when a PIE distributes money to investors.

Productivity: A measure of the rate of output per unit of input.

Progressive: A progressive tax rate structure has higher rates for higher levels of incomes.

Provisional tax: A tax administration regime that requires some taxpayers to pay income tax instalments during the year on income that has not had tax deducted at source (for example through PAYE).

Purchasing power: The value of income or currency in terms of the goods and services that it can buy.

Real return: This is the nominal return adjusted for inflation. It is a closer estimation of economic income compared to the nominal return because it preserves the value of capital over time. (See also: nominal income.)

Regressive: A regressive tax has a higher rate for lower levels of incomes.

Risk-free rate of return: This is the expected rate of return that a completely risk-free investment generates. The difference between the risk-free return and the expected return on a risky investment is sometimes called a risk premium.

Robot tax: A tax on the use of a robot that replaces a human worker.

Rohe: the territory of an iwi.

Rollover relief: In the context of taxation of capital income, rollover relief delays taxation in certain circumstances when a capital gain is realised.

SME: Small and medium-sized enterprises.

Social capital: The norms and values that underpin society. It includes things like trust, the rule of law, the Crown-Māori relationship, cultural identity, and the connections between people and communities.

Social security contributions: Compulsory payments to government that provide an entitlement to receive a future benefit.

Sole trader: A person doing business in their own name with no separate legal entity.

Tax Policy Work Programme: A programme (with periodic updates) signalling the Government's plan for current and future tax policy work.

Tax secrecy: The set of rules that requires Inland Revenue to maintain secrecy on all matters relating to tax legislation.

Te Ao Māori: A Māori world view.

Tikanga: The custom, rules and lore associated with a Māori world view.

Transfer system: Government spending paid in cash rather than in kind, including benefits and Working for Families tax credits.

Trust: An arrangement whereby a person (a trustee) holds property as its legal owner for one or more beneficiaries.

Trustee income: For a trust, income that has not been allocated to a beneficiary is trustee income. The trustees of the trust are jointly liable to pay the tax on trustee income. (See also: beneficiary income.)

Universal basic income: An unconditional payment from the Government to all eligible citizens.

Value-added tax (VAT): A VAT is a type of transaction-based consumption tax that is levied at each stage where value is added in the production process and at the point of sale. New Zealand's GST is a form of VAT. (See also: GST.)

Vertical equity: The principle that those with higher income or assets should pay higher amounts of tax. (See also: Horizontal equity.)

Welfare Expert Advisory Group (WEAG): A working group set up by the Government to undertake a broad review of the welfare system. The WEAG will provide a report to the Government in February 2019.

Whanaunatanga: A Māori concept encompassing relationships and connectedness.

Windfall gain: An unexpected increase in wealth or income.

Winding up of a company: The end of a company's existence (also known as liquidation).

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