

Tax Working Group Public Submissions Information Release

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Submission to the Tax Working Group

Submitted by: Craig Hastie

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Future of Tax

In a thorough and comprehensive consideration of any taxation regime it is my opinion that the matters to be considered and the order in which they should be considered are as follows –

- (1) What do the citizens of a country want the state to do?
- (2) How much taxation is required to fund the activities decided upon in (1)?
- (3) How should we go about collecting the taxation required under (2)?

Question (1) is fundamental, for if we do not know what we want the state to do (and therefore equally what we do not want the state to do) then we have no basis to answer questions (2) and/or (3). In my opinion there has never been a full debate in this country on question (1) and, in my opinion, your Tax Working Group is not tasked with comprehensively answering this question. This question would likely take several years to adequately answer. However, if this question is not answered then how can one answer question (2) and then question (3)?

Purpose of Tax

In my opinion the sole purpose of taxation is to fund the activities of the state, with such activities being determined by the citizens of the country. This therefore requires a thorough answer to question (1) above. I submit that until you have a clear and unequivocal answer to question (1) you are in no position to determine any “purpose” question.

In my opinion the state has no legitimate role to play in determining how its citizens should act without a clear mandate to do so from its citizens. For example, does the state have a role to play in determining how its citizens deal with alcohol, tobacco etc. or are these matters best left to individual choice? As a further example, in your paper you state that people are concerned about income inequality and, by implication, the state should somehow address this matter; however you provide no evidence in your paper to support such an assertion. Hence I question why you should be addressing the matter of income inequality in your review without a clear direction from the people that they are concerned about this. In summary, again you need to answer question (1) before you can start to answer the question on the purpose of tax.

Are we taxing the right things?

Once again without a complete answer to question (1) above how can one answer this question?

We currently have two main forms of taxation in New Zealand – income tax and GST. Of the two GST is the simplest and most logical.

As a practicing Chartered Accountant with over 30 years experience it is my opinion that the Income Tax Act is simply a “mess” – it no longer has any coherent and rational basis throughout. Successive Governments have amended so many sections in an ad hoc manner that the Income Tax Act is now extremely large and often

contradictory. Different sectors of the economy are often taxed in completely different ways (e.g. farming compared with most other businesses) simply because it suited a Government of the day to do so for political reasons. In my opinion a fundamental review of the Income Tax Act needs to occur but can only occur in a sensible way when one knows what it is we need to raise taxation for and, therefore, how much taxation is required.

In various reports your group has mentioned that it will look at several areas of taxation. In the next paragraphs I will address some of these.

Residential Rental Property Investments

On many occasions politicians and other commentators have commented that people and entities that invest in residential rental property gain an unfair income tax advantage. As a practicing Chartered Accountant I submit that this is nothing more than a myth. I submit that there is not a single section in the Income Tax Act, 2007 that specifically applies to residential rental property businesses that gives them a taxation advantage over investing in any other income earning asset. I submit that the rules applying to residential property investors under the Income Tax Act, 2007, as it is currently written, are the same rules applying to investing in any other income earning asset. For example, with the exception of some sections that disadvantage them (e.g. limitations on depreciation), the same rules apply to investors in residential rental properties on capital account as apply to investors in plant and equipment for leasing on capital account. As a simple example both can claim a deduction for interest on borrowings to purchase the asset being leased and both have an exemption from income tax on capital gains made on sale.

There has been comment in the media that we should have a Capital Gains Tax (CGT) on residential property in New Zealand. In my opinion the main reasons for capital gains on residential property is simply inflation. Hence a CGT on residential property in NZ is little more than a tax on inflation. Another reason often stated for a CGT on residential property is that people often buy and sell a property for a short term gain and do not pay tax – I submit that this is already taxable under current provisions of the Income Tax Act (e.g. sections CB 6A to CB 15B or the Bright-line Test).

One proposal that has been suggested to remove the supposed advantage that investors in residential rental property get under the Income Tax Act, 2007 (a myth – see above) is to “ring fence” the losses so that they can only be offset against current or future year rental property profits. If this is accepted by your group then why should this not also apply to losses from any other form of investment? Furthermore, the Income Tax Act, 2007 does not refer to “profits” and/or “losses” but income and deductions (the Income Tax Returns as prepared by the Inland Revenue Department incorrectly, in my opinion, net the two). Hence, if you are to ring fence losses for residential rental property investments, you will have to amend the Income Tax Act, 2007 to define what you mean by profits and losses and how those are to be calculated (e.g. is an accountancy to prepare financial statements for a residential rental property and to prepare the actual Income Tax Return itself going to be required to be apportioned (remembering that a Return preparation fee is a specific deduction under the Income Tax Act, 2007 and if the financial statements are required in order to prepare the Income Tax Return then should not all of the accountancy fee be deductible? What if there are multiple inter-related business activities undertaken by the same entity - how are expenses that apply equally to the different activities to be apportioned?)

It is my opinion, based on comments by politicians and the media, that there is a shortage of residential housing available for lease in New Zealand. Any further rules that negatively impact the supply of residential rental properties will further reduce that supply and, therefore, increase the cost of renting. Ultimately, the law of supply and demand, will mean that the consumer (i.e. the tenant) will ultimately “wear the cost”. In my opinion, any changes to taxation that could potentially reduce the supply and increase rental costs should be carefully thought through and the consequences and responsibility for any increased rental cost clearly explained to the public.

Over recent years a significant number of rules have been enacted placing increased costs on landlords. With more costs being imposed in the next few years, the threat of “ring fencing” residential rental property losses and a possible CGT on residential rental properties some landlords will take the opportunity to exit the residential property market. It is estimated that for every residential rental property exiting that market 2.3 additional houses will be required. As you say, with housing becoming increasingly unaffordable do you really want to put in place measures that will decrease supply and therefore increase demand and, hence, cost? If you doubt this will happen, I can personally advise that in our small practice we have already seen clients exiting the residential property market for these stated reasons!

In conclusion, I submit that there is no requirement to consider any changes to the rules in the Income Tax Act, 2007 which relate to residential rental property investment.

Capital Gains Tax/Inheritance Tax/Wealth Tax

It has been suggested that we need some form of tax on “wealth” (whatever is meant by that). Mostly a Capital Gains Tax (CGT) is mentioned.

In the late 1980’s/early 1990’s a comprehensive CGT was investigated at considerable length. The proposal was never pursued for many reasons, some of which were –

- Under the proposal all assets were to be subject to the CGT. There was a suggestion that the family home might be exempted.
- For assets owned before the implementation date of the CGT it was never resolved whether the gain to be assessed was the difference between the historic cost and the sale price or the difference between the open market value at the date of implementation of the CGT and the sale price.
- If the gain to be assessed was the difference between the historic cost and the sale price then this would require all assets in New Zealand to be valued as at the date of implementation of the CGT. It was soon realised that there were not enough valuers in the world to undertake this task.
- If the gain to be assessed was the difference between the historic cost and the sale price then this would tax virtually the entire sale price of an appreciating asset held over periods of high inflation and/or held for a long period of time. This was deemed to be particularly unfair as the owner was unaware for most the period of ownership that the tax would apply.
- Would capital losses be deductible against other taxable income or ring fenced so as to only be deductible against other capital gains?
- Should the tax be imposed in an incremental fashion, i.e. every year on the increasing value of an asset? It was determined that the valuation issues and costs, even if only for real property, would be enormous. It was also determined that this would also, potentially, create significant financial hardship for those holding assets with significant increases in value over time but no cash income related to that increase in value to pay the resulting tax.
- If there were to be exemptions for any class of asset (e.g. the family home) how would they apply?
- Studies of overseas jurisdictions with a CGT showed that CGT’s tended to have very high administrative costs both in the state sector (i.e. the tax collection authority) and the private sector, particularly when litigation costs were considered (most CGT’s tend attract considerable litigation). Indeed, the CGT raised was often equal to these costs. Hence there was little net economic gain for the state.

I understand that subsequent studies have reached the same conclusions. Hence why we have not had a CGT/wealth tax implemented in New Zealand.

As justification for a CGT/wealth tax one often reads in the media that because other countries have one we also should have one. This is clearly a nonsensical argument. Other countries have nuclear weapons. By that logic we should also have nuclear weapons! If a CGT/wealth tax is a poor form of taxation then it is simply a poor form of taxation.

According to reports I have read the NZ state currently collects about \$80b p.a. in taxation, forecast to rise to \$100b p.a. in the next 10 years. All estimates I have seen suggest that the most comprehensive form of a CGT/wealth tax would collect, at most, \$1-2b p.a. I submit that this is a trivial amount in the overall tax take. I believe that this amount of extra income could more easily be gained by simply having the Inland Revenue Department more rigorously enforce the existing income tax rules.

In conclusion, with regard to a CGT/wealth tax I submit that little has changed from earlier studies. That is, there is no rational reason to implement a CGT or any other form of a wealth tax.

Goods & Services Tax

In my opinion the GST legislation is currently, generally, well written and effective.

In my opinion the only question to ask in regards to GST is – is it comprehensive enough? For example, why are financial services and residential rentals exempted? Exemptions always cause problems. For example, consider the Court case between the IRD and Databank over whether or not Databank in processing financial transactions was providing a financial service that was therefore exempt from GST (eventually decided that it was not) or consider the confusion around property developers providing short term residential rental accommodation whilst trying to sell a residential development property. In my opinion consideration should be given to bringing financial services and residential rentals into the GST base.

It has previously been suggested that certain “essential” foodstuffs such as fresh fruit and vegetables should be exempt from GST. I note that these suggestions have only ever come from people who have never personally prepared a GST Return. As a practicing Chartered Accountant with considerable experience in dealing with small businesses such exemptions cause no end of compliance issues. Some simple examples of compliance issues if fresh fruit and vegetables were to be exempt from GST –

- A definition of “fresh” would be required, e.g. consider apples which have been in a coolstore for 12 months – are they fresh? What about after 13 months? What about two year old potatoes?
- A definition of “fruit” and “vegetables” would be required. For example, one MP suggested to me that mushrooms would be exempt GST as they are a foodstuff; however mushrooms are a fungi, not a fruit or vegetable. By the MP’s definition edible flowers would be exempt, but these are also neither a fruit or a vegetable. Overseas these types of questions have required significant Court cases to resolve at considerable cost to all involved. For further (short) reading, please look at the BBC article “Is VAT suffering a mid-life crisis at 40?” for examples of peculiar cases that were worth hundreds of millions of pounds in the United Kingdom, due to various seemingly clear carve-outs.
- A retailer selling fresh fruit and vegetables along with other products (which would be subject to GST) would need to apportion their operating expenses (e.g. rent, power, insurance etc.). This is in the same manner that banks have to when they offer services subject to GST (e.g. the sale of insurance policies) and those services not subject to GST (e.g. general banking services). This apportionment is difficult and complicated leading to significant compliance costs.
- A typical corner dairy often sells fruit and vegetables. Most of these are registered for GST on a payments basis and cannot afford a complex computer system to record their sales and purchases. When they prepare their GST Returns they simply add up all the deposits into the bank account for their income and add up all the expenses that they know are subject to GST (e.g. purchases from the local food wholesaler) for their expenses. A relatively quick and simple process, generally taking less than one hour every two months. If fresh fruit and vegetables were to be exempt GST they would need to keep a very detailed record of all their sales and purchases and undertake an equally onerous analysis as well as apportioning some expenses when preparing the GST Return. All of which would take a very significant amount of time – at best many hours. If it really is necessary to consider making food cheaper for people why not either simply have the state provide everyone with an annual voucher that they can redeem or provide a state grant or allow the retailer to claim a rebate from the state for all fresh fruit and vegetables sold that they can pass on to consumers by way of cheaper prices? Any of these would be much simpler and cheaper to administer.

It is my opinion that GST is currently a very efficient taxation methodology. It is hard to avoid and businesses have no reason to do so. Therefore, if additional taxation is required I suggest that your group consider raising the rate of GST.

Other than considering extending the scope of GST and a possible increase in the GST rate it is my opinion that GST requires no amendments.

Can we make housing more affordable?

This is an interesting question. What do you mean by affordable? Affordable to who? Until you define this how can you answer this question?

Is the question that you are really asking – can the cost to build and/or purchase and/or rent a house be reduced? I assume that this is really the question that you are asking and, hence, what I will address here.

In my opinion the biggest barriers to reducing the costs of housing are –

- Too much red tape imposed by the state and local bodies related to the cost of building a house. For example, and from personal experience, I would estimate the cost of all state and local body regulations to build an average house costing \$450,000 at about \$30,000. Solution – reduce compliance costs and obligations.
- The law of supply and demand. From media reports it would appear that Auckland residents face the biggest housing costs. To put it simply the demand for housing exceeds the supply in Auckland. The solution - either increase the supply (e.g. by increasing the supply of land in the area available for housing or build more apartments) or decrease demand (e.g. by encouraging people to move away from Auckland to areas with much lower housing costs (e.g. Invercargill)). Related to this is that wages for many in Auckland appear too low for them to be able to afford suitable housing there – solution – encourage people to move out of the area, as the labour supply decreases wages will go up - simple supply and demand again.

Does taxation have a role to play in housing costs? In my opinion, not really. Builders, developers and speculators are already caught under various sections of the Income Tax Act, 2007. It has often been stated in the media that overseas residents purchasing property to sell for a short term gain have significantly increased property prices in New Zealand and Auckland in particular. I have challenged proponents of this view on this matter and asked them to provide a single real example yet none ever have. Perhaps it has happened, but I wonder if it is another “urban myth”. As far as taxation is concerned, if it has happened the question to ask is not whether we need new tax laws but rather why the IRD has not enforced the existing laws.

Finally, it is my opinion that a CGT/wealth tax on housing, particularly residential rental properties, will only make the existing situation worse by further increasing the cost. As previously stated, any increased cost will, ultimately, in my opinion be passed onto the consumer in higher house prices and higher rental charges.

Therefore, it is my submission that taxation is a poor method to use to attempt to reduce the cost of housing and this option should not be pursued.

Conclusion

It is my opinion that without answering the first question that I asked any comprehensive and meaningful review of the current taxation system is pointless. If we do not know what we want the state to do how can we possibly know what resources, including taxation income, are required?

For the reasons outlined, in my opinion –

- (a) No review is required of the current Income Tax Act with regard to residential rental properties.

- (b) The GST Act as currently written is generally working well. Consideration should be given to extending the application of the Act to financial services and residential rentals in order to simplify the working of the Act. Under no circumstances should consideration be given to exempting further activities such as the sale of fresh fruit and vegetables.
- (c) A CGT/wealth tax is simply too complex and difficult to implement in a manner that will bring in significant tax revenue.
- (d) A restriction of losses from and a CGT/wealth tax on residential rental properties will only further increase the cost of housing.

I would be very happy to meet with your group to discuss any issue that I have raised in this submission or if I can assist in any other way.

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C. A. Hastie

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