Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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Submission to the Tax Working Group ("TWG")

***"It doesn't matter whether a cat is black or white, as long as it catches mice"*-Deng Xiaoping**

From: Arthur Jacobson

Enrolled Barrister and Solicitor of the High Court of New Zealand
Chartered Accountant (CAANZ)

My Experience

I have worked in Tax for 40 years including 28 years for the Big 4 in New Zealand, London and Hong Kong and for 12 years with Reuters Ltd, an FTSE 100 company, latterly as Group Tax Manager, responsible for Group tax affairs in all OECD economies (and many others). My submission is made on the basis of this practical experience and hence deals with all the set criteria except "equity and fairness"; while I fully understand that this is as important as the other 5 criteria, my lack of expertise means that I cannot usefully comment on it.

Summary of Major Points and Recommendations

1. As a general observation and as noted by the TWG, our current system is simple (in tax everything is relative!), broad based and low rate. It stands up well against other OECD tax regimes and, almost uniquely, produces a budget surplus and impressively low debt/GDP. In other words; **it works.** Why would we want to break it in a quest for an unattainable perfection? Specific submissions follow.

2. A capital gains tax will introduce commercial inefficiencies and technical complications out of proportion to its fiscal benefits. If the real target is the widely referenced "speculator", then enforcing the current law relating to acquisitions subsequently "flipped" would go a long way towards meeting the objective. A useful simplifying change to ensure compliance would be to replace the current (hard to prove) subjective intention test with a rollout of the real estate bright line test across all asset categories. If real estate is the specific target, ring-fence income losses.

3. However, if a full capital gains tax must be introduced, it should be on a **realised** basis with capital losses ring-fenced. The tax rate imposed should decrease with length of holding and/or a system of rollover relief should be utilised.

4. A global wealth tax would not meet the noted criteria, particularly "revenue integrity". If a diversification away from income and consumption taxes is absolutely essential, a land tax is preferable, albeit flawed.

5. A narrowing of GST should be avoided at all costs. The complexity and inefficiencies of boundary issues outweighs any benefits. Any social relief from perceived unfairness should be addressed by increased benefit payments perhaps funded by a rise in the GST rate.

6. Some or all input from Treasury will be based on macro-economic cycle impacts on societal wholes or classes. To this extent it is inapplicable to the detail of annual/transactional tax assessed at the micro-level on individuals and single legal entities. Treasury submissions on micro issues should, therefore, be carefully critiqued. Similarly, consideration of submissions from professionals (such as lawyers and accountants) should bear in mind that their income is inversely proportional to the “efficiency”, “integrity” and “coherence” of the tax system!

7. Lastly, a general warning. Introducing necessarily complicated capital gains tax, wealth tax or revised GST regimes would threaten self-assessment by increasing complexity. It would encourage non-compliance, both deliberate and inadvertent: how many taxpayers fully understand the current realised/unrealised capital gains tax on financial arrangements or the FDR/CV FIF regimes; both of which taxpayers have a legal obligation to self-assess? How would even an expanded IRD cope?

Detailed Submissions

Capital Gains Tax/Stamp Duty

- In my experience, where there is a capital gains tax, all planning activity is around how to avoid/minimise this rather than achieving a rational economic structure. Thus a large amount of commercial activity is wasted for a tax which, typically, collects insubstantial revenue.

- If the target of a capital gains tax is the widely referenced "speculator", then current law exists in the form of subjecting to income tax any profit on the sale of property acquired with the intention of disposal. The current problem with this law is proving requisite intent. An easy fix to this problem is a rollout, across all asset classes, of the bright line test now applicable to real property only. This would obviate the need for a capital gains tax targeted at speculators.

- If the specific target is real estate arbitrage between income losses and capital gains, then ring fence income losses. At a minimum this would prevent any income tax subsidisation of capital gains.

- Thus, I believe, there is no cost/benefit basis for a general capital gains tax and it should be avoided unless absolutely required on "equity and fairness" grounds (which I do not comment on).

- My remaining submissions assume that a capital gains tax will be introduced and are suggestions on how to design this to ensure minimum economic and personal disruption:

    - It should only be imposed on a realised basis. Unrealised taxation might currently cope (just) for financial arrangements where interest rate, and hence market value, movements are glacial and the assets are typically liquid. But for other assets it could be ruinous; think bitcoin volatility and see my attached real world example as submitted to the FEC in 2006. For the draft foreign equity FIF rules, Treasury had opined that an unrealised tax on market value changes was merely an appropriate proxy for income over time. This completely ignored the annual assessment scheme of our tax system and that losses cannot be carried back (only forward). My real world example showed that, in the context of the 2000 dotcom crash, by merely holding all the Reuters shares that I acquired while employed by Reuters (ie. no acquisitions or sales), I would hold shares worth $36,000 but have a tax bill of $100,000. Luckily, The Hon. Shane Jones, then FEC chairman, saw the absurdity of the Treasury position and introduced the 5% FDR alternative to unlimited market value changes/CV. I trust the TWG will likewise see through nonsensical ivory tower submissions by Treasury and its ilk (see below).

    - To avoid ossification of asset holdings, bright line tests such as are currently used for real property should be introduced but in bands; eg owned up to 12 months-100% taxed; 12-36 months-75% taxed;36-60 months-50% taxed and so on. Clearly, a **necessary** component of such a system, to avoid gaming, would be a ring fencing of capital losses.

- Alternatively, or additionally, a wide rollover relief basis could be used. By way of analogy you might buy an apple tree to make income off the fruit. You then find your soil is no good for an apple tree, so you want to buy a pear tree of equal value but prices of fruit trees have generally risen and capital gains tax payable on a sale of the apple tree prevents changing. So you are forced to remain engaged in sub-optimal apple growing. Rollover relief ameliorates this position and tax is typically collected as assets are cashed in, say on retirement or death. This is more equitable and prevents distortion of economic activity but revenue collection is delayed.

- A stamp duty likewise ossifies both commercial and private (real estate, vehicles etc) transactions. It would require a costly new enforcement regime to prevent commercial avoidance by, eg, overseas signature of commercial contracts. Also, in the professional units of my legal qualification (mid-1970's) it was noted that "*gentlemen don't make stamping objections*"; ie. unstamped documents were not enforceable in Court but blind eyes were turned to this. In practice only resident individuals are punished by a stamp duty making it even harder to afford a house (see recent UK developments as an example) or other stampable assets.

Wealth/Land Tax

- A wealth tax on all assets would be complicated and, with exchange controls long abolished, could lead to assets being hidden abroad. This, in turn, could lead to reductions in other tax collection (ie no declared dividends or rent from hidden shares/property). NB: The 5% FDR rate on FIFs is effectively a current wealth tax on foreign holdings of equities.

- Thus, again, a wealth tax should be avoided unless absolutely required by "equity and fairness".

- If required, it should take the form of a Land Tax on New Zealand land only. While less fair than a whole of wealth tax, collection would be simple and uncomplicated with no evasion possible. Presumably those paying this tax could spread it over the economy generally through increased rents etc but this area is outside my field of expertise.

A Narrowing of GST

- Increasing exemptions from GST to lower the cost of food, sanitary products etc should be avoided at all costs. This leads to interminable boundary issues, ie large "compliance and administration costs". Rather, if absolutely necessary, GST should be increased and the extra revenue collected passed, via some mechanism, to those suffering from the GST imposts on the targeted items.

- Boundary issues cannot be avoided. While I worked in the UK, there were court cases over whether a traditionally named "Jaffa Cake" was, in fact, a "cake" and therefore exempt "food" or, rather, taxable "confectionary". Also, to tax takeaway food, there was a rule that food sold above ambient room temperature was taxable. Supermarkets and bakeries put

bread straight from the oven onto their shelves to lure customers with baking aromas. Was it taxable for the 1st 30 minutes while hot and thereafter exempt?; always taxable?; always exempt? In another case cold food consumed on premises was taxable but if taken home to eat was exempt. So what happens if a sandwich shop customer tells the counter staff they are taking the sandwich out (therefore exempt) but then sits at the counter and eats it. Do they have to accost the customer and demand VAT/GST? There are endless examples!

Treasury and Professional Firms: A Warning

- I have encountered a number of economic bodies including the nonsense produced by NZ Treasury in support of 100% annual unrealised taxation of FIFs as an earnings proxy (see appendix). The problem appears to be that Treasuries (the EDB in Singapore is an exception) think over multi-year economic cycles and fundamentally consider the macro impact of these on society or societal classes/groups as a whole. Tax is an annual (or, for GST, transaction by transaction) impost charged at the micro level on individuals and other single legal entities. In my view, Treasury economists have no understanding of any of the 6 noted criteria necessary in a real world tax regime. The production of graphs, flow charts and endless strings of equations does not affect this assertion.

- The issue with professional firms (lawyers and accountants) is almost the opposite. They fully understand the criteria and, in particular, “efficiency”, “revenue integrity” and “coherence”. The issue is that their level of earnings from tax advice services is inversely proportional to a tax regime meeting such criteria. Any submissions from professional firms should bear in mind the inherent underlying financial motivation and should be particularly assessed in light of the criterion of “compliance and administration costs”.

Complexity/Threat to Self-Assessment

- Any of the above-mentioned considered changes (except a land tax) would inevitably increase the complexity of the NZ tax system which, currently, relies on self-assessment with selected IRD audits to keep taxpayers honest.

- A large number of taxpayers would not comprehend that the new taxes affect them and would just ignore them (as do a lot of cash basis taxpayers with the current financial arrangement rules). Given IRD resources, in the vast majority of cases there would be no consequences. The net result would be that diligent taxpayers who understood their liabilities would be penalised relative to the ignorant who just ignored any new taxes.

- Partially as a result of this, the current self-assessment system would be under threat. The IRD would need returns from stockbrokers as to share transactions, from banks regarding all off-shore transactions (assets hidden from wealth tax) etc. but would struggle to collate all this data to determine who should be subject to the exponentially larger number of audits necessary.

Summary

- We are a small country with a limited IRD resource. We cannot afford or effectively administer an overly complicated tax regime. We have a current tax regime that is fair to taxpayers and produces government surpluses at appropriate points in the economic cycle and has, relative to jurisdictions with capital gains and wealth taxes and with stamp duties, produced low government debt to GDP

- Fine-tuning is appropriate such as rolling out bright line tests in order effectively to tax speculation. However, it would be ruinous to overreact and destroy the working tax system we currently have.

"Plain goose lays gold eggs
Wring neck, buy preening peacock
Siren call! no eggs!"

With apologies to Basho Matsuo

Appendix:

2006 Submission to FEC re Proposed FIF Regime

To the Finance and Expenditure Committee

on the Taxation (Annual Rates, Savings Investment, and Miscellaneous Provisions) Bill

Introduction

1 This submission is from Arthur Jacobson.

2 I wish to appear before the Committee to speak to my submission and can be contacted as per the letter attaching this submission.

3 In 1997, after 17 years abroad, I returned to New Zealand on the basis of being able to fund my retirement with a balanced diversified portfolio under then existing tax laws. While abroad, I largely practiced in the field of international tax and am a Chartered Accountant (NZICA) and a Barrister and Solicitor (High Court of NZ).

4 I, therefore, believe that I am qualified to comment on the Offshore Investment rules being proposed from both professional and personal points of view.

Submission

1 I have spent 14 years working as a tax consultant for "Big 8"/Big 4" accounting firms in New Zealand, Hong Kong and London and also 12 years in the London based Head Office tax department of Reuters Ltd, the final 6 as Reuters "Group International Tax Manager" in which position I was responsible for the tax function in all major OECD economies.

2 Some countries have capital gains taxes and some do not.

3 Those that do, levy them on a full range of assets, not on a narrow class which distorts rational retirement planning.

4 Where there is a capital gains tax, it is levied on actual capital gains. It is not, by voodoo economics, called a tax on proxy earnings and then levied on unrealised changes in value. If proxy earnings were truly what is being taxed, then a standard return or published "earnings per share" approach could readily have been adopted.

5 I am often consulted by UK based colleagues who I know from my time there, both New Zealand expats and Brits, about emigrating to New Zealand.

6 In the past, I have been enthusiastic about recommending New Zealand. Now I tell them that if they are happy to invest exclusively in the volatile Australasian equities market or in real estate, they will be welcome.

7 If, on the other hand, they wish to maintain a balanced international equity portfolio, they must suffer vicious and discriminatory taxation and be prepared to be marginalised by the government as "high net worth individuals ready to take out full page advertisements in the major dailies", ie not "real New Zealanders" worthy of equitable treatment.

8 "Real New Zealanders", lulled into the sense that the new rules only affect undeserving fat cats, then fall into the trap by putting their money into diversified managed funds. These funds then, "under the sheets", pay the government the same unrealised capital gains tax and also deduct fund manager fees, generally levied on gross funds rather than profits.

9 The "real New Zealander" then reaches retirement and wonders why her/his investments have lagged market indices by such a huge margin and why they are unable to afford a comfortable retirement.

10 This treatment will not be tolerated for long. Eventually even more people will realise that, with real estate, they can pay no tax due to depreciation, there is no capital gains tax and, if they use agents, they will pay fees of a single digit percentage of actual revenue, not a fee based on the gross value of the property. It really is a no-brainer!

11 Turning to my personal position, during my 17 years in the UK, I built up a portfolio of diversified international funds. As UK tax resident but not UK domiciled, I could hold non-UK funds entirely tax free. I also acquired shares in my employer, Reuters Ltd.

12 I decided to return to New Zealand because of a young family and checked that tax on diversified investments, while more than in the UK, was fair: due to the Grey List, it was.

13 Upon my return in 1997, I put my funds into a family trust. This was to protect my family; not for tax reasons, as 33% was then also the top tax rate for individuals.

14 When the new rules appeared in the Discussion Document, I checked how they would have affected an **actual** core holding of 12,500 shares in Reuters. The answer is that, under the new rules, even though my family trust had held the shares throughout with no sale, it would have faced **a tax bill for either $126,845** (based on cost) **or $83,110** (based on MV at date of return to

NZ) but **the same Reuters shares** would have a value of only **$35,981** to meet this bill. Details are set out in the attached appendix.

15 How would it benefit the New Zealand economy to ruin taxpayers with a corrupt tax like this? All it will do is encourage evasion which, once started (and successful due to non-enforcement by IRD even of the existing FIF rules), will spread even to equitable taxes.

16 Personally, I do not want the hassle of acquiring and managing a real estate portfolio and do not want to risk my retirement to the volatile Australasian share market. Luckily, I have a flat in the UK and have right of entry. I can therefore bail when family circumstances permit; others might not be so fortunate.

17 In closing, I note that it is not a pretty sight for ministers and their allies, secure in their guaranteed taxpayer funded inflation linked pensions, to deprive any New Zealander of the opportunity of a similarly secure retirement.

Appendix

Just before returning to New Zealand, I purchased 12,500 shares, under employee share schemes, in my employer of 12 years, Reuters Group PLC, intending to hold them long term in my family trust in view of the excellent dividend payout;

1 these **cost** me **$55,000** (Stg 2(cost)*12,500*2.2(Stg/NZ$ on 30/4/96).

2 On the date of my **return to NZ** these were worth **$210,917** (Stg 7.06 (MV) *12,500*2.39(Stg/NZ$ on 7/1/97).

3 On **31 March 2000**, at the height of the dot.com boom, these were worth **$507,210** (Stg 12.72(MV)*12,500*3.19(Stg/NZ$ on 31/3/2000).

4 On **31 March 2003,** after the crash, they were worth **$35,981** (Stg 1.01 (MV)*12,500*2.85(Stg/NZ$ on 31/3/03).

Under the new rules, even though my family had held the shares throughout with no sale, it would have faced **a tax bill for either $126,845** (based on cost) **or $83,110** (based on MV at date of return to NZ) but had **only related assets of $35,981** to meet this bill (the post 2000 losses would be useless as they could not be carried back).