Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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Submission to the Tax Working Group **Richard Brent 29 April 2018**

Brief Summary of major points

- **Tax relief for retirement savings.**
- **Tax relief for businesses and employees moving out of Auckland to regions.**
- **More user pays for use of DOC facilities.**
- **Tax relief for people saving for 1st home.**
- **No land tax**
- **Modification to Bright Line Capital gains tax to further reduce speculative activity**

Questions for Submitters

Chapter 2: The Future environment

And Chapter 3: Purposes of and principals of a good tax system

Both of these questions are related, and also part of the wider question of how the taxes collected are spent. This is outside the scope of this review.

In the near to medium future the tax system will have to cope with an increased proportion of the population being past retirement age. This has been predictable from birth statistics, so should not be the cause of any great surprise.

Assessing the effectiveness of a tax system and defining fairness are totally subjective. While most people accept a need for taxes to pay for infrastructure, beyond that opinions will vary. There is an understandable preference for people to be happy for taxes to be levied on other people. For example, people who own a second property are generally not in favour of a capital gains tax, whereas people who do not own a second property, and in particular those who are owner occupiers in Auckland are more than happy for a capital gains tax with themselves excluded. People on lower or no income are quite happy with the progressive nature of the income tax system, whereas people on relatively modest incomes paying the top tax rate, are not so happy. Again, all tax payers probably have preferences on how their tax should be spent. Should private or public enterprises provide services? These questions are outside the scope of this review, but nevertheless have an impact on how people might respond to it.

Chapter 4 the current New Zealand Tax System

Frameworks

The current tax system is fit for purpose, and apart from a bit of tweaking here and there, it does not need any dramatic change.

Taxes and behaviour

Taxes can be used to promote desirable behaviours. However, the revenue raised from such taxes should be carefully targeted towards mitigating the behaviour they are designed to alter, as the ideal outcome is that they would reduce to zero as they achieve their purpose. For example, if there was no income from tobacco tax, because nobody smoked any more, that would be the most desirable outcome. There are more comments on this addressed in the specific challenges section.

Retirement savings

The tax system should give every encouragement for people to save for and if possible become self-sufficient in retirement. The contributions into KiwiSaver should have further tax relief. There would also be advantages in making KiwiSaver compulsory.

Chapter 5: The results of the current tax system

Fairness and balance

The tax system has moved towards addressing this balance in part with the capital gains tax on property if sold within two years of purchase and recently increased to 5 years. See specific challenges and design of a capital gains system for more comment on this. The productive economy is a difficult one to define. As stated, productive vs speculative suggests the productive economy is defined as people who pay income tax. However, not all income earning activities are productive, for example overly complex and poorly drafted tax law creates an industry of tax accountants and lawyers who arguably are not as productive as workers on a building site.

An ongoing issue of unfairness, is that the level at which each tax rate starts under a progressive income tax system comes down with inflation. Those levels should be indexed against inflation. With the massive inflation of the 1970s and 80s, people on relatively modest incomes ended up paying the top tax rate.

Tax and business

Filing tax returns and all the record keeping that accompanies it is a cost to business. The simpler the tax system the lower the cost to business. It is preferable if taxable transactions are electronically filed with IRD so that the business does not have to manually file the same transaction. This appears to be progressively implemented between IRD and businesses already.

I am not familiar with businesses profiting from excessive deductions and/or timing of deductions and/or non-taxable income, so no comment.

Chapter 6: Thinking outside the current system

There are inconsistencies in the current tax system, but these contribute to rather than reduce the fairness of the system. Taxes are levied by governments to pay for things deemed necessary by society. However, where the benefits of a service are only enjoyed by a select few, it may be more appropriate for a user pays regime which is not normally considered as a tax. The example mentioned in the background paper are the use of DOC huts. Tourism has reached a point where there has to be a user pays regime to pay in part for the facilities which are so desperately needed. Tolls charged for entrance to National Parks and DOC walks, might not be considered as taxes, but would help target users to pay for the facilities they use rather than the general taxpayer.

Chapter 7: Specific Challenges

Housing affordability

The median house price to median wage ratio is clearly too high. In Auckland wages would have to rise at 3% per annum and house prices would have to remain static for 36 years for

this ratio to reduce from 8.8 down to 3. In Christchurch with a current ratio of 5.4 it would take nearly 20 years.

To correct this situation in a shorter timeframe, either house prices have to fall, or wages have to rise (significantly).

House Prices

There are two components here, land price and building cost.

The land price component can be reduced by making more land available. This can be achieved by:

- Zone changes, that is, creating zones where high density housing replaced existing low density housing.
- Expanding onto rural land.

Both of these solutions are the responsibility of local authorities rather that central government and re zoning is difficult politically and expanding brings with it ever increasing infrastructure costs.

The tax system could be used to encourage people and businesses into places with cheaper housing and land. By world standards New Zealand is unusual in that Auckland is approximately the same size as the next 6 largest metropolitan population areas added together. This migration to Auckland is economically inefficient for the strain it puts the rest of New Zealand to pay for Auckland infrastructure while there are underutilised resources elsewhere.

The other part of the equation is median income. The tax system cannot raise wages directly but could give tax breaks for people saving for their first home. KiwiSaver already has the provision for use as a 1st home deposit, but the contributions are still fully taxed. The tax could be reduced even to zero for a ring fenced 1st home deposit savings fund.

Other tax initiatives to improve housing affordability

Because land is in limited supply particularly in large metropolitan areas prices can be artificially pushed up by speculative activity. A paper by Burman and White written in 2009 includes data from the Statistic New Zealand Survey of Family Income and Employment (SoFIE) dated 2004. Of all the household assets which would be likely to experience capital gains over time, property (including owner occupied housing) make up 70% of all assets held. This is made up of 56% owner occupied properties and 14% investment properties. The further breakdown of investment properties, speculative, rental, private use, is not given. The next section on capital gains tax discusses the characteristics of these categories further.

Short term speculation is likely to put upward pressure on housing prices, and especially if properties are purchased by overseas investors (with more money at their disposal) for this purpose. The Capital Gains tax on properties held for less than 5 years should reduce this type of activity, although different weightings could be used to eliminate it almost completely. See Appendix for a suggested Capital Gains tax design.

Capital gains tax

We already have a capital gains tax which taxes capitals gains as income if a property (other than the family home) is sold within 5 years of purchase. This is a start. Capital gains are not income in the normal sense, as the gains, when realised, are not regular or reliable income, and while the past few years have shown strong gains, during the 10 years following the 1987 share market crash the property market was going backwards or stagnant at best. The other difference is that if capital gains are taxed with no time limit, tax payers would have to keep records for an unreasonably long time, and it would be difficult to verify the accuracy of such records. For example, parts of a house might be upgraded more than once, so that any evidence of a previous upgrade would be destroyed.

Properties, other than the family home, could be broken into three categories:

1. Those purchased for speculative purposes.

Properties in this category are likely to be held for a short period, and the owner will tend to buy and sell reasonably often. The other distinguishing characteristic is that they are likely to be highly geared.

2. Those purchased as income generating rental properties.

Properties in this category will require the filing of tax returns for rental activity, so are easy to identify. These properties tend to be held for longer periods of time. A test of whether a rental property is intended to generate revenue could be determined from the amount of interest claimed. If it is highly geared, it will generate little taxable net income. If there is a record of the owner reducing the mortgage, it is more likely to be an income generating asset rather than an asset held for capital gains. It should be possible to devise a test based on the amount of interest claimed as an expense, to determine the difference. It should be noted that rental properties are part of the housing mix, so care has to be taken not to make changes which push up rents unnecessarily.

3. Those purchased for occasional use by the owners, that is the family bach.

This category is often properties which are held for very long periods, and often stay in a family for several generations.

The Bright Line test is designed to tax the speculators who probably have the biggest impact on housing affordability. This could be tweaked a little, and I have documented my ideas in the appendix to this submission.

Land tax

Of the categories above a land tax would hit bach owners, but would be legitimately passed on to tenants for rental properties. Speculators generally keep properties for short periods and so would not be greatly affected. It comes into the same category as rates and would raise revenue and be easy to administer. However, it is a form of double taxation, and as such it cannot really be seen as a fair tax. It is not that local authorities aren't already taxing land as much as they can get away with.

Environmental taxation

This is a difficult topic given that there are a lot of complex interrelationships in the economy. For example, dairy farming is responsible for much of our green-house gas

emissions. We could tax some part of the process which would inevitably lead to higher prices for dairy products. This tax component of dairy products could be seen as the same as the tax on tobacco products. Do we really want to treat those the same? In the end such taxes are regressive, as it is only lower income families which suffer. In short, the tax system is probably not suitable for fixing our environmental problems. Other government policies and regulations are better placed to deal with environmental problems.

Progressive company tax

This would seem reasonable, although large companies are often structured as one holding company with lots of business units which are separate companies. This could enable large companies to become a lot of small companies for tax purposes, although there are probably ways of preventing this. Small businesses would benefit from any simplification of the tax system, as compliance can be a significant cost.

GST exemption for particular goods

There is already GST exemption on a few transactions such as rents which are a distinct service and financial transactions which are apparently too hard to manage, but also quite distinct. Extending exemptions to goods has problems of definition. Exempting GST on "healthy food" for example immediately raises the question of what is the definition of healthy? Back in the days of sales tax, there were the same items used by different industries which attracted different sales taxes. An example was a printer used in the printing industry attracted a sales tax of 10 % whereas in the computer industry it attracted 40 %! The system was complex and inefficient.

While varying GST rates might appear to have some merits, it would may open a can of worms in implementation and interpretation. At the moment it is simple and efficient.

Appendix

Design of a capital gains tax

If you think that the Group should design a capital gains tax (CGT) for Government consideration, we need your feedback now on a number of detailed design issues

Should the CGT be a separate tax or part of the income tax? Most countries tax capital gains as part of income tax.

In order to dampen the component of rising house prices due to speculation I believe there should be some form of CGT on land with or without houses on that land. CGT should be separate from income tax as this allows more flexibility to target property prices increases specifically and the speculators who profit from these rises. It would be a dangerous to see such a tax to use for revenue gathering, as it would depend on speculative activity, and would effectively reward a government for failing to control property prices. Ideally, the tax take would be low with property prices being roughly in line with general inflation.

Should capital gains be taxed on an accrual basis or only when realised (i.e. only when the asset is sold)? Most countries tax on a realisation basis. How should matrimonial property settlements and disposal of assets at death be treated?

CGT should be collected on disposal not an accrual basis, as this would require ongoing valuations which are always hit and miss whereas the value at disposal is concrete. Matrimonial investment property should be taxed for capital gains if it meets that taxable criteria. An issue arises which would need to be clarified. If one partner buys the other partner's share, should that be treated as a sale of the complete property, with both partners paying CGT, then the remaining partner buying the property at what be a new purchase price, which would be off set against the sale price at a later date. Alternatively, the selling partner could pay CGT on the half share at the time, and the buying partner would have the complete property but the two halves or it would effectively have different purchase prices, and dates of purchase. Subsequent improvements made would then be offset against which half?

For investment properties belonging to a deceased party, disposal of the property should be taxed as if the deceased had disposal of the property themselves.

What assets should be covered, given that the terms of reference exclude any tax on the family home? Should it include just rental properties, shares, collectibles, private assets such as cars.

CGT should apply to land with or without buildings, and possibly shares Shares are a different type of asset, and a CGT on shares may need to be treated differently with the proviso that shares in companies which only owned property did not allow arbitrage between two different tax processes. A difficulty is that property speculation may be enacted over a periods of months, whereas speculation on futures may be enacted over minutes or hours.

Records relating to the buying and selling of other assets are haphazard at best and would be difficult to police. However, the existing tax system allows for the taxing of regular trading when IRD believe it is an income generating activity. As rental housing is an integral part of the means by which people are housed it may be worth considering an exemption for this category if other criteria were met, as a CGT on this form of investment might push rentals up to compensate, and also drive investors out of that form of investment thus pushing up rents because of lack of supply.

Should assets held by KiwiSaver and other savings schemes be taxed?

KiwiSaver assets should be exempt CGT .

Retirement saving should be encouraged, and not taxing KiwiSaver assets should encourage people to join. The difference between KiwiSaver and other savings schemes is that withdrawals can only be made in certain circumstances, so the non-taxing of assets could not be used as a tax avoidance vehicle.

Should assets held offshore be subject to tax?

Assets held overseas by New Zealand tax payers should be dealt with the same as assets held in New Zealand. If the overseas administration also levied a tax, this would have to be taken into account when calculating New Zealand tax liability.

How would a capital gains tax integrate with current tax laws, such as when land sales are already taxable, our company imputation system and our CFC/FDR rules.

No comment

When should non-residents be subject to tax?

Non-residents should be taxed by the same rules as New Zealand residents. Advertisements targeting foreign speculators have been common since the early 2000s. This question may no longer apply since many foreign buyers are now prevented from buying New Zealand property.

Should capital losses be ring-fenced to be offset only against capital gains income or should they be offset against any income? If capital gains are taxed on a realisation basis, tax base maintenance considerations suggest that capital losses should be ring-fenced.

Ring fencing would seem appropriate.

Should there be roll-over relief allowing capital gains re-invested in similar assets to be treated as unrealised? If so, when should roll-over relief apply? For example, should a farmer selling a farm and buying a new farm be taxed on the increase in value of the old farm?

Yes. If the investment is like for like, there would presumably be tax levied when that type of investment was finally exited. Each time an investment was rolled over the clock could be reset to zero, so that under the existing bright line test, the 5 years would start again. For example, roll-over relief would be appropriate where an existing rental property could not economically be brought up to new standards for such properties, so disposal and purchase of a more suitable property would be appropriate.

How should death, emigration and immigration be handled?

No Comment.

How should gifts and gambling winnings be taxed?

Gifts of taxable assets such as property would have to be subject to CGT to prevent one party "gifting" a property to another then the second party "gifting" some money back to the first party. However, gifts in general should not be taxed. Gambling is usually a loss-making activity, so should not be taxed.

What should the rate of tax on capital gains be - the normal income tax rates, or some other tax rate(s)?

One of the drivers of a CGT is to reduce speculative pressure on house prices. It would therefore make sense to have a very high tax rate initially and reducing over time. A suggested formula would be a 100% tax payable for an initial period, say one year, then a linear (or other) reduction from 100% down to 33% over the next 2 years, then a flat 33% from 3 to 5 years followed by a linear reduction to zero at 7 years. The rationale behind this approach is that property speculation would become unviable. Having an end date also allows for potential taxpayers not to have to keep records for excessive periods of time, the current requirement being 7 years, and does help prevent the "lock in" effect by allowing for

some turnover of investment property. It avoids having to account for capital improvements even building replacements occurring over an indefinite period.

The formula for the above for linear reductions would be:

Round up to the nearest whole number of months for which the asset was held = m

For m=0 to 12 months Tax rate on Gain – expenses = 100 %

For m=12 to 36 months Tax rate on Gain – expenses = (133.5 – 67 x m/24) %

For m=36 to 60 months Tax rate on Gain – expenses = 33 %

For m=60 to 84 months Tax rate on Gain – expenses = (115.5 – 11 x m/8) %

For m > 84 months. No tax

Supplements to a CGT could be:

Requiring part or all interest claimed during the holding of a property to be paid back out of the capital gain at disposal time. This would prevent excessive gearing which is often an indication that an investment has been made for capital gains.

Limiting the frequency of disposals (this is already part of the bright line test for some properties)

Should any allowance be given for inflation in calculating capital gains?

An allowance for inflation would seem fair.

Should there be a de minimis rule?

A de minimis rule would apply where the cost of administration was larger than the amount of tax gathered. However, if a tax is well designed and implemented electronically the cost of administration should be low.

What rules should govern the transition into a capital gains tax? The options seem to be cost of assets (retrospective taxation of past accrued gains), valuation at date of introduction or only assets acquired post introduction (the Australian rule).

New Zealand already has a "Bright Line" test for capital gains, so there will be tax payers who have been keeping records of capital expenditure since its introduction. However, taxpayers who have held properties for longer periods may not have records for past capital expenditure as they would not have been required to keep them. A clean start with existing disposals dealt with by the rules in place at purchase time would avoid such problems. All taxable assets purchased after an implementation date would be tested against the new rule (if there is a new rule) at that date, and continue to be so.

How should family trusts be integrated into the system?

Trusts should be dealt with as any other taxpayer. However, my knowledge of the law around trusts is limited, so they may be other considerations.