Tax Working Group
Te Awheawhe Tāke

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Summary

In my submission, I seek:

1. A continuation of the present broad-based low rate taxes;
2. A review of the land gain provisions
3. A review of the provisions for the taxing of gains from the disposal of other property
4. The establishment of a Tax Commission or similar body to provide a means for a more systematic review of the implementation of new tax rules

I make comments on the possible design features of a general capital gains tax (CGT) although I am ambivalent about the desirability of such a tax.

Submission Background

This is a personal submission that is not made on behalf of any clients.

It is, however, one made with the benefit of 35 years of tax law experience that has covered a very wide range of entities and transactions. I have litigated a moderate number of tax cases, and I have resolved many more tax disputes.

I studied tax in 1976 and 1980 (in NZ) and in 1981-82 (in USA). I have written and lectured on many tax topics, as well as having created a lot of tax training resources (for Inland Revenue). I also have seven years of government tax panel experience – Rewrite Advisory Panel (as independent Chair) and GST Advisory Panel. I have also appeared before the Finance and Expenditure Committee as a submitter on numerous occasions (from 1985 onwards) and have been a Specialist Advisor to that Committee.

My submission is also made with the benefit of a few years of living (by deliberate choice) in a Deprivation-10 suburb (also classified as Decile-One for educational purposes) in order to provide support to disadvantaged members of our society, including ex-prisoners. Affordable housing is a problem within New Zealand.

A. Future of Tax

In my view, New Zealand ought to have a tax system with the following features:

- Broad-based low rate taxes, but with a progressive rate structure for individuals;
- GST and income tax of a similar nature to the present rules;
- No death duties or stamp duties;
- Better correlation to international norms, e.g. superannuation and employee share schemes taxed in a manner that do not create distortions when individuals migrate;
- Simplification of the process for individuals and SMEs for tax disputes;
- Appraisal of some historic tax rules such as land gain rules that are lack consistency and do not reflect the current environment (with the Resource Management Act) and have adverse consequences in encouraging "land-banking";
- A Tax Commission or similar body to provide a means for a more systematic review of the implementation of new tax rules, and for the review of older provisions, and as a more public/transparent way of keeping tax policy requests and submissions in the "public square".

A.1 Capital Gains Tax

I am ambivalent about the possible introduction of a Capital Gains Tax. On the one hand, the lack of a general capital gains tax is a gap in the New Zealand tax system and one that creates a degree of unfairness and some lack of horizontal equity. On the other hand, implementation of a CGT without a systematic review of the Income Tax Act provisions relating to dispositions of land and of personal property (like shares) will result in problems and disputes for years. It is not possible or realistic to simply add CGT to the tax system.

A CGT ought not, in my submission, to be imposed as a full rate income tax. Rather there ought to be some differential rate. However, the adding-on of a CGT to the ITA in its current form would be a simplistic approach and one that would cause problems in implementation. Simply put, there would be many winners and many losers if there were no review of the existing provisions of the ITA so that there would be appropriate synchronising of CGT and other taxing provisions in the ITA. I refer to Appendix 1 where I highlight a number of problems with the land gain provisions.

A.2 Challenges and Risks

The recent high rate of success of Inland Revenue in litigating tax cases creates a challenge to public perceptions of fairness of the tax system. A high rate of success would seem to be appropriate where there is a "perfect tax system", but that is an unattainable goal. There are compromises that are made in the development of tax policy, but these do not now receive appropriate testing through the courts. Tax policy judgments made by tax policy officials, with the benefit of submissions by specialist advocates, may provide the best answer, but there is not much opportunity to test the appropriateness of those judgments. The Select Committee process does not get many "grass roots" submitters.

I am not criticising the GTPP itself, but I wish to note that it was developed at a time when tax disputes were easier and cheaper to resolve. If there is no economically viable way for difficulties in the tax system to be explored, then the tax system will get trapped in a form of time warp so that it will not reflect our society and economy.

An example that I proffer to the Working Group are the land gain provisions (partly considered in Appendix 1) – there have been few cases in the past 20 years. One aspect is the "work of a minor nature" exclusion was effectively eliminated by the enactment of the Resource Management Act so that subdivision processes are never "minor". A second aspect was the widespread practice of house renovations undertaken for the purpose of deriving profits, with the corollary of inflating house prices thereby removing (or at least impeding) affordability. It is not yet clear whether the bright line test (of 2 years of ownership) created greater availability of affordable housing, while my speculation is that the 5-year bright line test will simply encourage land-banking. A third aspect is that a small number of local authorities have been changing their district plans in order to permit intensification, but there are potential adverse tax consequences for existing landowners through the operation of section CB 14 of the ITA so that a well-advised owner will not release land for intensification until the expiry of the 10-year period of ownership. Another aspect is that some tax advisers take the view that section CB 14 can apply to virtually every property where a resource consent is or might be granted under the RMA.

There is no longer much development of tax provisions through tax disputes identifying weaknesses in the tax system so that there can be measured and balanced reform. The detailed and elongated tax disputes process detracts from taxes being fashioned so as to suit societal and business developments. Instead, the focus on new tax provisions for larger taxpayers means that smaller taxpayers are becoming increasingly frustrated with tax rules that do not seem to make sense.

B. Purpose of Tax

In my view, the tax system is a mechanism for the fair and equitable raising of Government revenues.

Although the large-scale processing capabilities of Inland Revenue have been used to implement other collections, such as Student Loans and Child Support, I am of the view that any similar enlarging of the tax collection functions will be counter-productive. In my view, the non-tax functions of Inland Revenue create a lack of specialisation.

Tax provisions should be evaluated against their impacts on our society and our economy. And they should all be evaluated by way of post-implementation reviews.

I do not favour a tax system that creates incentives for taxpayers. It may appear cheaper to administer incentives through the tax system, but this comes to taxpayers with the potential cost of tax disputes.

C. Are We Taxing the Right Things?

The tax rules relating to the taxation of the disposal of shares are, like the land gain rules, worthy of re-appraisal.

The rules contained in sections CB 1, CB 4 and CB 3 are difficult to apply. They were developed before the development of modern approaches to investing – they encourage a *laissez-faire* approach to the management of investments by trusts and other entities, as well as by individuals. The development of Portfolio Investment Entities (PIEs) and of tracker funds with favourable tax rulings means that the tax system indirectly affects the investment choices of individuals. It is risky from a tax perspective to undertake direct investment. But did any Parliament decide that it was desirable to have tax advantages for these funds over individuals and other entities making their own investments?

I have made a number of comments on the land gain rules in this submission.

I acknowledge that my concerns with the existing provisions could be construed (or actually misconstrued) as support for a general CGT. My overall position is that I am ambivalent about a general CGT. However, I do wish to state my view of the appropriate design features:

- There should still be some taxation of gains as income gains. In the USA, short-term capital gains being disposals within 12 months are effectively treated as ordinary income;
- There should be a differential tax rate so that the rate of CGT is less than the ordinary income tax rates;
- All assets held on the commencement date ought to be within the taxing provisions (but on the assumption that there is a differential tax rate for CGT);
- There should be simplified rules for the determination of commencement date opening values of assets;
- There needs to be an implementation programme comparable to that used in 2010 for the rate change for GST, because there is every likelihood that the implementation of a CGT will result in the need for some special rules to be enacted;
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Appendix 1: Land Gain Provisions

The land gain provisions are poorly understood by most persons who acquire land. In particular, I note that the widely stated adage that "there is no CGT in New Zealand" leads many immigrants into problems.

The land gain provisions reflect the horizontal expansion of New Zealand in the post-WWII period when rural land was developed into urban housing (often with the then common quarter-acre section).

There have been reforms of the operation of the associated persons rules. However, there still remains the intricate overlay of rules covering (a) purposes and intentions, (b) "tainted" businesses, (c) subdivision and development, and (d) zoning changes, together with the different exclusions. They are best described as trying to drop a ping-pong ball through a log jam. In my submission, the lack of policy coherence in the land gain rules necessitates a review, rather than a simplistic replacement of the rules with a CGT.

I have recently become aware of a small number of local authorities proposing district plan changes that will enable intensification. This will enable areas of vertical expansion. When the language of section CB 14 is examined, it is apparent that the tax rule will (if correctly applied) impede intensification and the provision of more affordable housing. The provision applies where there is a district plan change (or the likelihood of such a change) and there is a 20 percent change in value of the land. The provision applies where the land has been owned for less than 10 years. This suggests that any owner of rezoned land needs to get a valuation in order to determine whether they are able to sell their land. I note that there is an exclusion for owner-occupied land, but not for rental properties.

Appendix 2: GTTP

The lack of reference to the generic tax policy process (GTPP) in the discussion paper leads me to reflect on the importance of a fair process for the development and maintenance of tax policy.

The lack of a mechanism for review of existing tax provisions is a problem within the New Zealand tax system. Although the GTPP stipulates that there will be post-implementation review is, my experience is that any such reviews often lack public consultation and do not involve an evaluation at an appropriate time. Evaluation two years after implementation is usually too soon especially if only Inland Revenue officers are consulted with.

The following list is of a number of provisions on which I have been a party to submissions seeking reviews, or where there is an apparent need to reconsider specific tax provisions. This list focuses on somewhat smaller provisions that are usually reviewed but some of these become larger issues over time. For example, I recall (to a limited extent) making submissions to the Minister of Customs about problems about Customs exemptions for small-value items that favoured overseas wholesalers over New Zealand wholesalers of books - this submission was made in the 1984 to 1986 period but it is likely that the implementation of GST took precedence. The problem has now evolved into the so-called "Amazon problem" under which imported goods escape the application of GST.

The list is:

- The refundability of imputation credits to tax-exempt charitable entities, where the non-refundability is inconsistent with the policy underpinning the imputation system;
- The restriction of eligibility to Māori tax authority tax status to entities that receive Treaty settlement assets and fisheries entities, where the policy basis for the restriction is hard to discern;
- The need for an evaluation of the large number of different Third Sector entity types and their tax status, as discussed with a member of the (McLeod) Tax Review in 2000-01 but where the Review had insufficient time to commence such a review;
- The tax exemption for veterinary clubs, given the potential anti-competitive effects;
- The tax exemption for Lloyds memberships given that the regulatory requirements in the UK now seem to preclude individual memberships;
- The operation of the non-profit society "exemption" which applies by way of a deduction (under section DV 8) so that the "exemption" applies to income of less than $1000, because the provision technically requires the filing of tax returns;
- The treatment of hedging versus speculation in derivatives, where the suggestion (made in the late 1990s) of a form of electronic drop-box for pre-notifications of tax treatments was seen as being too expensive for Inland Revenue to undertake.

In addition, I note that the work of the GST Advisory Panel in 2010 dealt with many, but probably not all, the issues that were latent in the GST system. In my view, there are still many issues in the GST sphere that need to be addressed.

I acknowledge that there may be adequate reasons for these suggested areas of reform not being considered. However, I do believe that the large resources used in developing large reforms means that there is insufficient resourcing of so-called smaller issues, which have greater societal impacts.

I submit that there is a need for a Tax Commission, or similar body, that has responsibility for maintaining the tax system. I note that the Tax Rewrite Panel came to provide such a forum, although my appointment in 2008 as its Chair was always seen as a sunset appointment for that body. It provided a forum for a focus on technical issues between the tax advisory professions and policy officials. In the absence of such a body, resource issues will always result in new taxes being prioritised over maintenance issues. In my submission, an omission to review **all** taxes creates the risk that the tax system is not fit for purpose.