Tax Working Group Public Submissions Information Release

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In preparing this Information Release, the Treasury has considered the public interest considerations in section 9(1) of the Official Information Act.

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[1]

29th June 2018

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Addendum to earlier submission on Capital Gains Tax

Pages 22 and 23 of Mervyn King's (the retired Governor of the Bank of England) book "The end of Alchemy" has the following excerpt.

The point is low interest rates have transposed into high asset values.

"….The bad was the rise in debt levels. Eliminating exchange rate flexibility in Europe and the emerging markets led to growing trade surpluses and deficits. Some countries saved a great deal while others had to borrow to finance their external deficit. The willingness of the former to save outweighed the willingness of the latter to spend, and **so long-term interest rates in the integrated world capital market began to fall. The price of an asset, whether a house, shares in a company or any other claim on the future, is the value today of future expected returns (rents, the value of housing services from living in your own home, or dividends).** To calculate that price one must convert future into current values by discounting them at an interest rate. **The immediate effect of a fall in interest rates is to raise the prices of assets across the board. So as long-term interest rates in the world fell, the value of assets — especially of houses — rose. And as the values of assets increased, so did the amounts that had to be borrowed to enable people to buy them.** Between 1986 and 2006, household debt rose from just under 70 per cent of total household income to almost 120 per cent in the United States and from 90 per cent to around 140 per cent in the United Kingdom.'

The Ugly was the development of an extremely fragile banking system. In the USA, Federal banking regulators' increasingly lax interpretation of the provisions to separate commercial and investment banking introduced in the 1933 Banking Act (often known as Glass-Steagall, the two senators who led the passage of the legislation) reached its inevitable conclusion with the Gramm-Leach-Bliley Act of 1999, which swept away any remaining restrictions on the activities of banks. In the UK, the so-called Big Bang of 1986, which started as a measure to introduce competition into the Stock Exchange, led to takeovers of small stockbroking firms and mergers between commercial banks and securities houses. Banks diversified and expanded rapidly after deregulation. ……."

I have emboldened parts of the above which describes accurately what has occurred to date.

I have reproduced my original submission below. It would be nice to get an official acknowledgement that you have received my thoughts and that they haven't disappeared into the Wellington ether of already preconceived ideas.

Regards

Graeme Berryman

Re CAPITAL GAINS TAXATION AND PROPERTY INVESTMENT

EXECUTIVE SUMMARY

1. **There are no capital gains on property other than speculative gains at times of currency or interest rate arbitrage**
2. **The assumption that there is always Capital Gains and no Capital losses, on property assets is not supported by historical data.**
3. **Attention should be directed to the overseas owned, New Zealand based subdivision activities where the land is purchased by use of the New Zealand Companies resources, but immediately transferred to the overseas domiciled Directors of the Company. When subdivision is undertaken the profit is taken tax free, by transfer at a new price back to the New Zealand Company who undertake the subdivision.**
4. **An all-encompassing Capital Gains Tax already exists and is called rates, which is a tax for services provided.**

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Above a copy of a 'Mr Parker's' THE WIZARD OF ID 'cartoon, which focuses on what is being discussed, the share to be paid and who receives the benefit of the present tax system.

CAPITAL GAINS TAXATION

I intend to address the field of Property ownership, Investment and taxation.

I have read numerous articles on Capital Gains Taxation together with the 'The Future of Tax' briefing paper, two features come to mind.

A. Glossary – **Capital Gains Tax (CGT)**: 'A tax on the increase in the capital value of an asset.'

   With respect this is not a definition of a Capital Gain.

   Unless you allow for the effect of inflation – which is a designed demand of Government, and the declining cost of borrowing for funding (see later), this is not a definition to create a new tax policy on.

   Inflation is not a Capital Gain and it appears that most of the present hysteria is associated with the activities of short term Investors who are only active on the periphery of the property market at limited times. Speculators are currently caught by the present taxation system, which has historically been poorly administered by the Inland Revenue Department.

   Around the period of the Global Financial Crises (GFC), there were wide spread reports of sharp declines in the value of property, with resultant mortgagee sales and with sale figures below initial purchase prices. Would it be the intention of a taxation system to provide a refund of the capital in this instance?

B. If a Capital Gains tax is introduced and it is across the board of property, then tax losses on property should be allowed for crediting and not ring fenced to one property.

The points I would like to make are as follows:

1. We already have in place a comprehensive and all-encompassing Capital Gains Tax on property. It is called RATES, which throughout New Zealand is levied on the CAPITAL VALUE of the entire property LAND and CAPITAL IMPROVEMENTS and currently are increasing at above the rate of inflation throughout the country.

2. The fact that rates are devoted to local issues, rather than central government issues, is a process of income sharing or sharing of the taxation which has been in place for some time, Local Government undertake some of the activities of Central Government in any case. Social housing is an example.

3. Central Government and the activities of the Reserve Bank are central to what has caused so called Capital Gains in New Zealand.

   3.1 Immigration is an acknowledged input to the CPI index and is an inflationary activity. Central government dictates the level of immigration into the country and leaves it to Local Government to cope without support to improve the needed infrastructure. Auckland is a prime example of underinvestment in roading, transport, utility services and social infrastructure required for a city of its size.

3.2 The Reserve Bank as a policy implementer of Central Government, are mandated to have a target of 1 - 3% inflation. The desire to have such a policy is to inflate away Government debt and to provide a sense of advancement in the community. Deflation has the opposite effect of greater political uncertainty and public disturbance i.e. Riots in Queen Street, Auckland during the Great Depression etc.

3.3 Over the last 30 years the Reserve Bank Act and its operations have been fiddled with.

A. At one stage Central Government dictated the amount of funds to be placed by 'Trading Banks' later including 'Community Banks', with Central Government to finance Central Governments funding requirements. This was applied during periods of expansion – 'Think Big Projects, electricity generation requirements in the 1950's etc.' and to control inflation and property price expansion.

B. The Reserve Bank has allowed the easy importation of funding from overseas jurisdictions which have flowed directly into house mortgages, with the effect of boosting prices and subsidising the Australian owned banks.

C. This policy has directly contributed to at least a 25% increase in so called Capital Values throughout New Zealand. Historically interest rates have been around 6.5% to 7% over the last 40 years. A drop to rates of around 4.5% equates to a 2 - 2.5% difference, which translated into Values is 20% to 25% in value terms. It could be argued that this is a low estimate of the effect of low interest rates. Our Country has never in the last 60 years had rates as low as currently available.

4. If property is viewed as a spread throughout the whole of New Zealand, what is actually taking place is as people leave country areas and move to the cities, demand for rural properties declines with the effect of a transfer of capital value from rural to urban centres.

5. No mention is ever made of application of a capital gains tax to Government and Local Body property.

6. Exemptions are normally proffered in regards to personal, 'owner occupier held' property; where in fact the real speculator element is prevalent in this group at bubble times in the market.

   I have no problems with couples buying a house and adding 'sweat' equity to increase their proprietorship in the property market, I do have a problem with silver spoon commentators, wanting to purchase property at the level attained by their parents

7. Property traders (speculators) pay tax presently on property gains if they are so classified, a similar tax charge is made for share traders, both where they are deemed to be earning their living from such activity.

8. Currently a claw back tax applies where property is disposed of and depreciation is claimed on the dwelling and chattels during ownership, which is a form of application of a capital gains tax. This is not consistent when the ultimate point of the chattels and the dwelling at some stage will be reach the end of their economic life and require replacement.

9. If such a tax was introduced and Government Policy was exempted, no real control would exist preventing the Government from printing currency similar to Zimbabwe and consequently destroying the intrinsic value of property ownership by over taxation. I remind the Committee that this occurred here in New Zealand in the 1970's to 1980's

10. Speculative gains have been taxed for some time. The Briefing paper refers to the taxation of property gains by means of Income Taxation.

11. Let me provide the following example by way of illustration. (See Reserve Bank printout attached)

    An associated Company of ours purchased in 1970, a domestic dwelling which has been rented on the rental market since purchase.

    Purchase Price - $9,500 (Nine Thousand Five Hundred Dollars),

    Current Rating Valuation $630,000.

    A so called Capital Gain of $620,500. Try selling the property at that figure and then having a change of heart and seek to buy it back at $9,500, if you can.

    The attached Reserve Bank CPI Inflation calculator for Housing comes out at $639,381.44, which shows that all of the so called Capital Gain has been by means of inflation, or the erosion of money value. I.e. in real terms over the 50 year odd years of ownership the value of the property has remained virtually constant.

12. The writer is aware of a sale of land in the Henderson area where overseas Owners/Directors sourced the land using their New Zealand Company, purchased the land and sold it back to the New Zealand Company, prior to development. The profit was taken prior to development and would no doubt be tax free.

PROPERTY OWNERSHIP MATTERS

The present coalition Government has to date adopted an anti-private landlord stance.

In my opinion this is an unfortunate attitude to take. Successive Governments have provided Social Housing by means of the State Advances Corporation and now Housing Corporation. This policy has been in place since the 1930's with recent Governments not greatly increasing the quality and quantity of housing provided.

As a compromise and to allow the provision of housing, private landlords have been encouraged to meet the need.

Changes to tenancy occupancy provisions placing greater liabilities and compliance burdens on landlords (e.g. rental W.O.F's) and other proposed changes will reduce the rate of return, leading to landlords withdrawing properties from the market restricting supply and increasing the price of the remaining accommodation. It is well acknowledged that the returns on residential tenancy are in the order of 2% – 4 % net after expenses (at best). Hardly a great rate of return and reflective of why there are no listed Public Corporations providing such a service – contrasted to the Residential Care sector.

Our company manages a number of properties for landlords. I would make the comment and it should be emphasised that **good tenants get good landlords**, with the corollary being that **bad tenants normally get bad landlords**.

Previous New Zealand Government policies have been responsible for the creation of the climate where private individuals seek to provide for their own retirement by means of the purchase of investment properties.

We have seen the rise and fall of the stock market in the 1980s aided and abetted by Government selling off public assets at discounted prices and in some cases the full funding by Government, providing a one-sided bet for inside operators/speculators.

Then we have experienced the collapse of finance companies around the period of the GFC, where individuals (many of them retirees) sought higher rates of return than available at the time through the banking system with ultimately disastrous consequences.

The attraction of property through the years has been a minor return, the provision of a social need and a **protection of capital as well as having a secure asset when others have failed.**

Most of the owners of properties which we manage are small business people, retired people or family homes which are rented, whilst a surviving parent/owner is in care – does a CGT tax apply to the latter?. Again how popular does a Government want to be if this asset is Capital Gains Taxed.

An ownership example (countless others are available), I can provide is where a parent has purchased a small unit which is let and provides an income for a Downs Syndrome child as a means of continuing support once the now surviving parent passes away.

Taxation changes have been made over recent times which affect the attractiveness of property.

1) Depreciation has been removed as a deduction for taxation. This is despite the fact that a dwelling has a limited economic or useable life which is acknowledged as not more than 100 years.
2) Proposals have been made to the deduction of repairs and maintenance to a dwelling. How this will run to maintain adequate housing is questionable.

3) It is worth remembering that GST on expenditure is not offset against rent received on residential property.

Mention has been made in the New Zealand Herald of the Reserve Bank introducing a charge on overseas sourced funds to stiffen the influence of the OCR rate assessed by them. This would be a more purposeful change, which could be made over time to tax the super profits generated as a benefit to banks and evident by the borrowing cheap money overseas and lending dear here in New Zealand. Additionally it is questionable why banking services are exempt from GST with an obvious huge subsidy being provided directly by central Government.

<u>OBVIOUS FAULTS IN THE BACKGROUND PAPER</u>

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"Some people have more than one option for structuring their business affairs, whereas others do not. For example, an employee will always have tax deducted at source by their employer through the PAYE system. A contractor doing broadly equivalent work may be able to conduct their business as either a sole-trader, a partner in a partnership, through a company or through a trust. Such decisions can allow tax rate benefits as well as the ability to access work-related *deductions* this has implications for horizontal equity."

No explanation is provided as to what the benefits of such an operation is. Do the authors think that work related expenses i.e. provision of tools, travelling expenses do not relate to the earning of an income?

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"As an example, consider a firm that can spend $9 to make $10 in revenue. If there is a 20% tax on profit then the firm will still have the incentive to make the investment as they will make a post-tax return of $0.80 (that is, 80% of the $1 profit). However, if instead the firm was not allowed to take deductions and there was a 20% tax on revenue, the firm will not make the investment because after tax they will make a $1 loss (they would be taxed $2 on the $10 revenue)."

This presupposes that all business activity is profitable. This is clearly not the case and in most cases it is hard to determine the exact profitability of any business activity.

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Wealth inequality

This is a simple fact of life, we are all born with nothing, some people accumulate, others dissipate. It remains a choice for them as to how they wish to live their lives. In fact Governments want to see consumption, rather than saving as the activity provides employment – Income Tax and GST.

TAXATION INCIDENCE

Appended to this submission is a schedule displaying the effective tax rates including the effect of G.S.T. A rather low income incurs tax of roughly 25% a slightly higher income 30% and the top income threshold 40%. A more equitable basis would be to make the first $10,000 of any income tax free, to allow for the imposition of G.S.T on the lower income earners. Accident Compensation Commission levies are included in the above whilst Kiwi saver payments are additional taxes to the above.

The submitter is available for interviewing if required.

Yours faithfully

Graeme Berryman
[1]

Definitions:

Sweat Equity: 'an interest in a property earned by a tenant in return for labour towards upkeep or restoration'

Are we trying to fix a problem which does not exist?
[1]