Tax Working Group Public Submissions Information Release

Release Document

February 2019

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New Zealand Shareholders Association Inc.
NZSA®
Many Investors, One Voice

October 2018

New Zealand Shareholders Association Submission to Tax Working Group

Relationship of Submitter

The New Zealand Shareholders Association (NZSA) is the only nationwide organisation representing the retail investor "buy side" of the market. We are recognised as such by all market participants including MBIE, regulators and listed corporates.

Our submission is written from the perspective of independent investors, many of whom hold shares in both New Zealand and offshore companies (primarily in Australia).

Executive Summary

Although NZSA understands the Governments desire for a Capital Gains Tax (CGT), the Tax Working Group (TWG) itself acknowledges that it is a particularly complicated tax to administer. A key feature of New Zealand's tax legislation, which has been widely recognised and lauded over many years, has been its simplicity. Unfortunately, many of the possibilities canvassed in the Interim Report would result in this no longer being the case. The complexity of a CGT significantly reduces its efficiency owing to high compliance costs. The introduction of a CGT is also likely to decrease efficiencies in capital allocation, as investors focus on limiting the increased tax burden rather than looking to optimise their asset allocation. The reality is that heightened complexity will turn people away from the capital markets.

We are particularly concerned with two aspects of the TWG interim report.

- Firstly, there are some recommendations where "form takes precedence over substance" resulting in different outcomes for the same basic transaction. This is never good law and will result in poor compliance.
- Secondly, the TWG interim report is seriously deficient in several important areas by failing to identify preferred options or even the options themselves. We are unsure how taxpayers and groups such as ourselves are expected to address what is in fact a fragmented and unfinished process. We are most concerned that this whole process is being rushed which undermines the opportunity for fully informed consultation.

However, if the Tax Working Group (TWG) determines to proceed with recommending a CGT, despite its disadvantages and high costs, then we believe that share investment should be exempt as the capital component is in fact already taxed. This is explained further below.

NZSA is strongly opposed to a CGT on unrealised assets, primarily due to the cash flow problems that would result for investors along with the recognition that unrealised gains can be transitory. Only realised gains should be liable.

There should be no exemptions, to ensure capital is not directed away from some areas to other less productive ones or to favour one type of vehicle over another. This will also require the inclusion of some asset classes that are proposed to be exempt.

Matters such as the rate of any CGT, ring-fencing or roll-over provisions are either not aligned with overseas regimes or introduce further distortions and unfairness as currently proposed.

We are concerned that direct investment in shares will be diverted to non-productive exempt vehicles. Not only will this result in limited CGT being paid but it may also deprive the capital markets of resources, resulting in sub optimal performance and leading to lower economic activity. The unintended consequence could be lower levels of revenue for the Government to either spend or redistribute, rather than the windfall gains expected.

An absolute certainty if a CGT is introduced is that a whole industry will spring up to advise on compliance and avoidance. Not only is this an expensive waste of resources, but it will disproportionately benefit the very wealthy who will find ways around the tax to the detriment of the clear majority of investors who are simply trying to provide for a more comfortable retirement.

If an additional tax on share investments is to be imposed, we believe that a Risk Free Return method tax would potentially be the most equitable and would be less likely to lead to unintended consequences.

NZSA has made limited comment on environmental taxes and taxation of overseas entities as these are peripheral to our mandate. In both cases we urge that responses are proportionate based on a combination of proper cost benefit analysis, international best practice and recognition of New Zealand's interests and sovereignty.

Submission on Specific Matters.

Capital Gains Tax on Shares.

The NZSA is concerned that the push to introduce a capital gains tax to share transactions fails to acknowledge that gains on shares are not tax free. This is a fallacy for the following reasons:

- Over time, a company's share price will approximate the net present value of future cash flows i.e. free cash flow
- Free cash flow is post tax cash flow
- It is already accepted in the TWG interim report that double taxation should not happen. Imputation credits ensure that dividend income for shareholders doesn't suffer this.
- Capital gains for shares predominantly reflect after tax retained earnings and the future incremental after-tax earnings that are expected to be derived from these retained earnings.
- Therefore, a CGT would represent a double taxation. The company will, as the cash flows arise, pay the tax. Any shareholder who sells his shares is in essence receiving post tax gains.

As a result, we can see no reason why a discriminatory double taxation process masquerading as a CGT should be introduced on share transactions.

The following notes are designed to address the most egregious consequences that might arise if a CGT is in fact recommended on shares once the currently incomplete TWG recommendations are finalised.

Capital Gains on Foreign Direct Investments

We note the Group has acknowledged the current FDR at 5% is excessive in relation the reality of income or gains actually achieved. This illustrates the problems of setting an arbitrary rate (in this case in 2007) and not reviewing and adjusting the rate to take account of the changes in the business environment resulting in it becoming both inappropriate and, in this case, excessive and inequitable to the taxpayer.

In addition, the complexity and high cost of complying with the existing FIF regime, especially for smaller portfolios is already a significant disincentive for investors to diversify.

In addition, we observe that the current FIF regime allows for a $50,000 exemption. This exemption was set over a decade ago and is now too low. The level needs to be reviewed and updated and a higher threshold should also apply to a CGT if this is introduced.

We are greatly concerned that if the FIF regime is maintained, the TWG plans to consider removing the "comparative value" option. We believe that this would be a backwards step that would unfairly penalise equity investors who invest in the knowledge that they will sometimes experience volatile returns. A "gains" style tax in years where investors have experienced capital losses is inequitable, harsh and is likely to discourage offshore investment.

Investment in Australian Listed Companies

New Zealand investors commonly invest in both New Zealand and Australian listed companies. The wider range of companies available on ASX allows for greater portfolio diversification. A disadvantage of investing in Australia is that, as a result of franking credits not being recognised, New Zealand investors are double taxed on dividend distributions. We are concerned that the impost of an additional tax, such as a capital gains tax, will unnecessarily discourage New Zealand investors from diversifying their investments to include ASX listed companies.

Exemptions

The TWG appears to favour an exemption for Kiwisaver, PIE Funds and possibly other managed funds. This would introduce a "form over substance" test which in our opinion would be bad law.

The effect would be to force investors into vehicles that often have high costs relative to returns. The stated intention of the review is to remove incentives to invest in one form of asset over another. We submit that forcing investors to use managed funds by means of an exemption does exactly the opposite.

In this case we would expect that an exemption equal to any benefit gained by managed funds should be available to direct investment in shares.

The proposal to exempt some classes of asset such as collectibles is another example of the discriminatory nature of what is being proposed. A surge in this type of asset investment is inevitable, particularly by wealthier investors who do not require regular income, unlike most direct share investors who seek income (which is taxed) to supplement their retirement.

Roll-over Relief

We are similarly concerned at suggestions for roll-over relief should be available to certain types of managed funds but not to individual direct investors. Again, this would introduce a "form over substance" test which in our opinion would be bad law. It would likely have the effect of forcing people into high cost managed funds rather than allowing the most efficient use of capital.

Rate of Capital Gains Tax

We are minded that other jurisdictions apply a lower Capital Gains Tax rate than the full marginal tax rate as recommended in the Report. For example, the US taxes short term capital gains at the ordinary income tax rate, but long-term capital gains are taxed at around 50% of the ordinary rate. A single taxpayer with income between US$38,000 and US$425,000 is taxed at a flat 15% on long term capital gains.

CGT on Unrealised Gains

We note with concern a suggestion that an unrealised capital gains tax in some form could be applied annually rather than the option of a tax being applied only to realised capital gains.

We believe that this would be unfair and inequitable. It would potentially lead to taxpayers being forced to sell down part of their portfolio to pay the tax. It would inevitably lead some taxpayers to invest into a CGT exempt asset (such as the family home or collectibles) resulting in limited tax revenue being realised.

Forcing the sale of some assets for other than sound commercial reasons is again the opposite of the stated intention to remove incentives for some assets at the expense of others.

Ring Fencing

The proposal that all capital gains should be taxable in full at the time the liability arises, but that capital losses should be ringfenced against future capital gains is completely unfair. The TWG characterises CGT as simply taxing "alternatively derived income". In that case, taxable income must include earned income and capital gains realised, less expenses to earn that income and capital losses realised. No other option than allowing capital losses, as well as gains, at the time they arise meets the criteria.

Risk Free Return Method

If an additional tax on share investment is to be introduced, NZSA considers that the most equitable form, with the lowest likelihood of unintended consequences might be the introduction of a risk free return (RFRM) based tax covering domestic and offshore listed share investments. A RFRM tax would be more predictable for investors and, as a result, would be easier to plan and budget for than a standard CGT on either realised or unrealised gains. A RFRM tax could also replace the FIF regime which would then result in a standard approach being applied to all share investments.

Capital Gains on Listed Debt Trading

The law currently addresses this issue with all gains whether from interest income or gains on sale being taxable at marginal rates.

Environmental Taxes

We believe any environmental taxes should be a balanced and proportionate response to clearly defined issues. They must be justified on the basis that the cost will result in at least an equal benefit. They should avoid unintended consequences. They should not just be imposed to placate international pressures but must recognise New Zealand's sovereignty. They should recognise New Zealand has a low-level contribution to global carbon emissions. They should not produce unreasonable negative economic and social outcomes. Taxes raised should be used to address the specific environmental issues identified not diverted to other areas. Nor should carbon trading schemes, that simply transfer poor environmental outcomes from one jurisdiction to another without actually reducing emissions, be countenanced.

International Income Tax.

NZSA acknowledge the Groups comments at Chapter 11 and its recommendations that the Government continues to participate in OECD discussions on the future of the international tax framework. We support the recommendation that the Government be ready to implement an equalisation tax if a critical mass of other countries (including Australia) move in that direction. We also support the recommendation that the Government ensures, to the extent possible, that our double tax agreements and trade agreements do not restrict our taxation options in these matters.

We are however mindful that there is significant public disquiet that international companies appear to pay very little income tax in relation to the revenue they derive in New Zealand.

We are also aware that international companies can use various devices such as intellectual property charges, service agreements and transfer pricing to avoid the same tax impost as a locally based company. We are concerned that these may be artificial in some cases and bear no relation to the realty of the situation.

We believe that to ensure the integrity of the tax system and demonstrate to New Zealand tax payers that the tax system is even handed, the Government must take the appropriate steps to address the current situation.

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New Zealand Shareholders Association