Tax Working Group
Te Awheawhe Tāke

Tax Working Group Public Submissions Information Release

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pwc

Tax Working Group Secretariat
submissions@taxworkinggroup.govt.nz

1 November 2018

Future of Tax Interim Report - The Tax Working Group

Dear Madam

Thank you for the opportunity to provide our feedback on the Interim Report of the Tax Working Group (TWG).

Extending the taxation of capital income

In our previous submission to the TWG we noted "*In our view, the introduction of a capital gains tax requires careful consideration to ensure a balance is struck so that the resulting tax will have the necessary features of a good tax system, including coherence, equity, fairness and low administration and compliance costs*".

With that in mind, we provide our comments on the some key design features should there be an extension of the taxation of capital income.

Key design considerations

The interim report notes that the taxation of capital income could be extended in two ways – that is, either via the introduction of a separate regime or as part of income tax and therefore taxed at the prevailing income tax rate of the taxpayer.

Our view is that any extension in the taxation of capital income should be incorporated into the income tax regime with the standard tax rates applying. We consider this approach should result in less complexity and ensures there is coherence with the taxation of non-capital income. It would provide less incentive for taxpayers to structure their affairs in a particular manner and also ensures there is fairness between the taxation of capital and labour income. Furthermore, it should mitigate the current tension that exists between the capital / revenue boundary.

In relation to the other design features, we note the following:

- *Risk-free rate of return method (RFRM)* – if the taxation of capital income is extended, we recommend that the TWG does not apply the RFRM on a wholesale basis. We believe that the RFRM could cause significant cash-flow difficulties for taxpayers and is also difficult for taxpayers to understand. However, we note that there may be certain types of capital income that would suit this method. An example of this is the current fair dividend rate method which can be applied for most portfolio share investments.

- *Accruals vs realisation basis* – it is critical that any resulting tax on capital income is applied on a realisation basis. If the tax is applied on an accruals basis, again, this could cause significant cash-flow difficulties for taxpayers as they may not have the necessary cash to meet their tax liabilities. It also may be difficult for taxpayers to calculate their capital income (e.g. including the need to obtain valuations).
- *Rollover relief* – we generally support the introduction of some form of rollover relief. However, it is critical that if the taxation of capital income is extended, a clear framework is established to ensure any rollover relief is coherent rather than ad hoc. This will help taxpayers to understand the policy rationale behind the rollover relief.

Consideration of capital expenditure

If there is an extension of the taxation of capital income, we strongly recommend that the TWG consider the treatment of capital expenditure, including the potential to re-introduce depreciation on commercial buildings and the current non-deductibility of black hole expenditure. In our view, some of the current restrictions around capital expenditure are a result of the non-taxation of some capital income. It would be unfair to disallow a deduction for such costs when where the capital income is taxable.

Ring-fencing of rental losses

We appreciate that the TWG is still considering the treatment of capital losses and the treatment of these is likely depend on other design features. However, we question whether the Government's current proposal to ring-fence rental losses should go ahead in light of the comprehensive consideration of the taxation of capital income by the TWG.

While we have yet to see the draft legislation for the proposal to ring-fence rental losses, this would be a significant shift in tax treatment for a number of taxpayers and would likely require taxpayers to consider new and potentially complex tax legislation. In our view, the ring-fencing of losses from a very specific category of income is not good tax policy design. Also, there is the potential that the rules may need to change or be repealed if the taxation of capital income is extended more generally. As such, we would recommend postponing the introduction of any ring-fencing of rental losses to a later date when decisions on the taxation of capital income have been made.

Taxation of Businesses

On balance we support the recommendations that the TWG have included in their interim report in relation to the taxation of small and medium businesses (SMEs). The recommendations will have a meaningful impact on reducing compliance costs and these will be felt more significantly for smaller businesses, for example, the increase to the provisional tax thresholds.

We think that there are other areas that the TWG should look into further, particularly due to their impact on SMEs.

The entertainment and FBT rules, and their interaction.

FBT in particular is an area with a high compliance cost for businesses, yet provides less than 1% of the total tax take. We understand that FBT is important for anti-avoidance purposes but a review with a view to simplifying the rules should be undertaken.

Taxpayers also struggle to determine what expenditure constitutes entertainment, and whether certain expenditure is subject to the entertainment limitation, FBT or neither.

The interaction of the entertainment and FBT rules results in significant compliance costs for taxpayers, and this will likely be felt more acutely for SMEs. This could be considered as part of a wider review of FBT.

GST change-in-use calculations

Another area where SMEs may struggle to comply is the GST change-in-use calculations. These rules are complex and specialist support is generally required when applying them. TWG should consider how these rules could be simplified, in particular for SMEs.

Charities

We are supportive of the inclusion of a wider review of the taxation of the charitable sector on Inland Revenue's work programme. There are currently a number of proposed changes to taxation of charities, but in our view a wider review is required to streamline the various definitions as they relate to charities. Coherence is required.

General

Finally, we note that the world is changing at a rapid pace and we are seeing signs of the tax legislation struggling to keep up. We urge the Government/officials to not become complacent post-TWG. There is a need to constantly consider and test whether the tax system serves the present state and by looking at it from a holistic basis, rather than considering it with a narrow lens.

We appreciate the opportunity for PwC to contribute our views and comments to the TWG on the future of New Zealand's tax system.

Please feel free to contact us should you wish to discuss our comments further.

Yours faithfully

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Sandy Lau
Director

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