Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

February 2019

taxworkinggroup.govt.nz/key-documents

This paper has been prepared by the Secretariat to the Tax Working Group for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

Key to sections of the Official Information Act 1982 under which information has been withheld.

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;
[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials;
[3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions;
[4] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

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

Coversheet: Extension of taxation of capital income – Agreed design features

Paper for Session 18 of the Tax Working Group
14 September 2018

Purpose of discussion

This paper summarises Officials' understanding of decisions that have been made by the Tax Working Group in relation to the design features of a potential extension of taxation of capital gains, based on Appendix B to the Interim Report. These decisions are discussed in detail in Appendix B.

This paper also notes issues that Officials understand the Group has not yet agreed.

The purpose of this paper is to ensure that Officials correctly understand the decisions that have been made by the Group. To that end, Officials request that the Group:

- confirm those items that have been agreed, where no further advice is needed;
- identify those issues where advice is still needed; and
- identify detailed design issues that the Group would prefer Officials to consider without further reference to the Group.

Officials note that the Group is still considering RFRM as an alternative way of taxing capital income. This paper does not address RFRM, which we anticipate will be discussed separately, and instead assumes that the extension of capital taxation will take the form of a comprehensive extension of the current income tax rules.

Recommended actions

We recommend that you **agree** to the Officials' understanding of decision made, as set out in this paper, with any modifications as necessary.

Summary of decisions

What income should be included

1. The Group has made the following decisions regarding the income that should be included:
   1.1 There should be a defined list of "included assets" rather than an extension to "capital gains".
   1.2 "Included assets" will be:
      1.2.1 interests in land (other than an excluded home) including residential, commercial, agricultural, and industrial land, and leasehold interests;
      1.2.2 intangible property;
      1.2.3 all assets held by a business or for income producing purposes; and
      1.2.4 shares and other equity.
   1.3 Assets expressly not covered by an extension of the taxation of capital gains will be:
      1.3.1 an excluded home; and
      1.3.2 personal assets.
   1.4 The exclusion for the "excluded home" should have the following features:
      1.4.1 The property has been occupied mainly as a residence by the person and their family as their family home or "centre of vital interests".
      1.4.2 The property is used as a family home up to the time of sale (however, some allowance can be made for a period of up to 12 months where the home is empty while it is held for sale).
      1.4.3 At any one time, the exclusion will only apply to one property owned by a person.
      1.4.4 The exclusion will only apply to people who are tax resident in New Zealand (taking into account the application of double tax agreements).
      1.4.5 The exclusion can apply to shares in a flat owning company, provided the person or persons who own the shares occupies the property as their family home.
      1.4.6 The exclusion can apply to a property owned by an ordinary company or look through company, provided the person or persons who own the shares occupies the property as their family home.
      1.4.7 The exclusion can still apply where the person temporarily lives in another place for up to four years.

1.4.8 The exclusion will apply to land of an area up to the greater of 4,500m^2, or the amount required for the reasonable occupation and enjoyment of the house.

1.5 The exclusion for personal assets will include cars, boats, other household durables, jewellery, fine art and other collectibles, but will not include assets acquired for resale, which will continue to be revenue account property.

2. There have not yet been any decisions made regarding:

2.1 What items of intangible property will be "included assets".

2.2 How the "excluded home" exclusion will apply to property held by a trust.

2.3 How the "excluded home" exclusion will apply where the home is also used for other purposes.

2.4 Rules for property that moves in and out of the tax base (ie, personal property/excluded homes that are subsequently used for income producing purposes or vice versa).

2.5 Specific rules for very expensive homes.

2.6 The treatment of real property located outside New Zealand.

When to tax

3. The Group has made the following decisions regarding when to tax:

3.1 Tax should be imposed on realisation rather than accrual in most cases.

3.2 The only exception to this should be for foreign investment funds (FIFs) that are subject to the fair dividend rate (FDR) rules.

3.3 A realisation event will include:

3.3.1 a sale of an asset for consideration (in money or money's worth);

3.3.2 destruction or scrapping of an asset;

3.3.3 deemed realisation where an asset leaves the tax base (eg, on migration);

3.3.4 deemed realisation where an asset is transferred for no consideration (eg, to a trust, shareholder, or in a relationship property settlement).

3.4 The following events should give rise to roll-over relief:

3.4.1 relationship property transfers;

3.4.2 transactions within a wholly-owned group;

3.4.3 when a business disposes of an asset involuntarily (eg, compulsory acquisition, or natural disaster) and reinvests proceeds in a replacement asset.

4. There have not yet been any decisions made regarding:

4.1 The extent to which roll-over relief should otherwise apply (eg, on death, gifts etc).

4.2 Whether a deemed disposal event will occur where significant expenditure is incurred in remediating damage to property (eg, for seismic strengthening or weather-tightness issues).

4.3 The time period for which an excluded home can retain its tax-exempt status when it is held in trust or rented pending sale or other disposal in the process of administering estates.

4.4 Whether there should be a rule deeming a trust to have disposed of property when certain events occur or time periods pass.

How to tax

5. The Group has made the following decisions regarding how to tax:

5.1 Income brought into the tax base by taxing more realised capital gains should generally be taxed in the same way as any other income.

5.2 Income should be taxed at a person's marginal tax rate, with no indexation for inflation.

5.3 Tax should be collected in the same way as other income tax subject to the possibility of a withholding tax regime in some cases.

5.4 There should not be any capital gains discount.

6. There have not yet been any decisions made regarding:

6.1 How capital gains are dealt with for the purposes of entitlements and obligations under social policy schemes.

Expenditure

7. The Group has made the following decisions regarding capital expenditure:

7.1 Expenditure incurred in acquiring an asset will be deductible from the sale proceeds at the time of sale (to the extent it has not already been deducted/depreciated).

7.2 Capital costs incurred subsequent to acquisition will also be deductible from the sale proceeds at the time of sale (to the extent that the expenditure has not already been deducted/depreciated).

7.3 Current law can be applied to distinguish between asset-related costs that are deductible when incurred, and those that are costs of capital that are depreciable or not deductible until sale.

7.4 Building related costs will be deductible on sale if they have not previously been deducted.

7.5 Expenses relating to the private use of residential property that is not an excluded home should not be deductible. This will include all expenditure that would be immediately deductible if the property was fully rented out (eg, rates, insurance, and interest costs).

7.6 No adjustment should be made to the cost base of an item of personal property to reflect private use.

8. There have not yet been any decisions made regarding:

8.1 Identifying the cost of fungible assets (ie, first in first out (FIFO), last in first out (LIFO) etc).

8.2 How the cost base of assets should be determined when they enter the tax base (eg, on migration or due to a change of use).

Treatment of capital losses

9. The Group has made the following decisions regarding capital losses:

9.1 Loss ring-fencing should apply to:

9.1.1 portfolio listed shares and derivatives not already subject to the financial arrangement rules, with losses only offset against capital gains and dividends from these assets;

9.1.2 losses from the sale of interests in attributing CFCs; and

9.1.3 losses arising from non-market transactions.

9.2 Losses on land held for private purposes should be denied entirely.

10. There have not yet been any decisions made regarding:

10.1 Whether further loss ring-fencing is appropriate depending on the extent of roll-over relief.

Transitional rules

11. The Group has made the following decisions regarding transitional rules:

11.1 The new rules should apply for all affected assets with effect from a certain day (referred to as the "valuation day").

12. There have not yet been any decisions made regarding:

12.1 How assets should be valued on "valuation day", including:

12.1.1 whether to impose a "median rule"; and

12.1.2 what valuation types should be allowed.

12.2 Whether the same valuation rules should apply when property enters or leaves the tax base (eg, on migration or through a change of use).

Taxation of shares in foreign companies

13. The Group has made the following decisions regarding the taxation of shares in foreign companies:

    13.1 Gains on the sale of interests in non-attributing controlled foreign companies (CFCs) by New Zealand resident companies should not be subject to tax.

    13.2 Gains on the sale of interests in non-attributing CFCs by persons other than New Zealand resident companies should be subject to tax.

    13.3 Gains on the sale of interests in attributing CFCs should be subject to tax for all New Zealand resident shareholders.

    13.4 Where a New Zealand resident company has interests in a CFC that are both attributing and non-attributing, the gain on sale will be taxable in the same proportion as the value of the assets giving rise to attributable income bears to the value of all assets of the CFC.

    13.5 The FDR rules should be retained for taxing interests in FIFs.

    13.6 Gains on the sale of portfolio interests in Australian listed companies should be subject to tax on realisation.

    13.7 Gains on the sale of other interests in Australian companies by New Zealand resident companies should not be subject to tax.

    13.8 Gains on the sale of other interests in Australian companies by persons other than New Zealand resident companies should be subject to tax.

14. There have not yet been any decisions made regarding:

    14.1 Whether the 5% rate for the FDR rules is still appropriate.

    14.2 Whether the option to use the comparative value (CV) method for individuals and family trusts should be removed.

    14.3 Whether the treatment for portfolio interests in Australian listed companies should be modified for portfolio investment entities (PIEs).

Taxation of non-residents

15. The Group has made the following decisions regarding the taxation of non-residents:

    15.1 Non-residents should only be taxed on realisations of:

        15.1.1 interests in land located in New Zealand (defined broadly);

        15.1.2 interests in companies deriving more than half their value from New Zealand land (other than for portfolio investors in a listed company); and

        15.1.3 assets of a New Zealand branch or permanent establishment.

Taxation on migration

16. The Group has made the following decisions regarding taxation on migration:

    16.1 When a taxpayer becomes non-resident, they should be deemed to have disposed of their assets for market value before their tax residency ceases.

    16.2 Where a person migrates to New Zealand, there should be a deemed disposal and reacquisition for market value on the first day they become a New Zealand tax resident (that is not a transitional resident).

    16.3 Sales of non-New Zealand property made by a transitional resident should not be subject to tax.

17. There have not yet been any decisions made regarding:

    17.1 Whether a deemed disposal on migration out of New Zealand should be made optional.

    17.2 Whether the deemed disposal would apply to all assets held by the person or only to those assets that cease to be subject to tax when the person becomes non-resident (eg, shares in a New Zealand company).

Taxation of partnerships and look-through companies (and their owners)

18. The Group has made the following decisions regarding the taxation of partnerships and look-through companies (LTCs):

    18.1 Gains and losses from sales of relevant assets by these entities will be taxable or deductible, and these gains or losses will be allocated to the partners/shareholders in the same way as other taxable gains or losses.

    18.2 Sale of a partnership interest/share in a LTC should be treated as a sale by the partner/shareholder of its share in the relevant assets.

    18.3 Sales of assets by a partner to a partnership in exchange for a partnership interest should continue to be treated as a 100% disposal for market value for the partner.

19. There have not yet been any decisions made regarding:

    19.1 The continued appropriateness of the *de minimus* rules in the partnership and LTC rules with regard to the sales of partnership/LTC interests.

    19.2 Whether there is a solution for the complexity arising from a new partner/shareholder having a different cost base for assets owned by a partnership/LTC than existing partners/shareholders.

Taxation of companies

20. The Group has made the following decisions regarding the taxation of companies:

    20.1 Assets held by companies should, generally, be subject to the rules taxing realised capital gains in the same way as assets held by individuals.

20.2 There should be different rules for sales of shares in group companies.

Taxation of New Zealand shareholders in New Zealand resident companies

21. The Group has made the following decisions regarding the taxation of New Zealand shareholders in New Zealand resident companies:

    21.1 In principle, it is logical to tax share gains in the same way as other property.

    21.2 In many cases, double deductions/double taxation issues that arise from taxing both the company and the shareholder on their capital gains are likely to be small or able to be mitigated, and don't require any special rules.

    21.3 If share gains are taxed, the shareholder continuity restrictions for imputation credits should be relaxed.

    21.4 On liquidation:

        21.4.1 To the extent that capital gains are taxable they will be taxable when distributed to the shareholders.

        21.4.2 To the extent that the shareholders would not be taxed if they held the assets directly, those capital gains should continue to be distributed tax free.

        21.4.3 Unrealised capital gains accrued before the introduction of an extension of the taxation of capital gains should be distributed effectively tax free.

        21.4.4 Where an amount distributed on liquidation is taxable as a dividend it should not also be taxable as sale proceeds.

22. There have not yet been any decisions made regarding:

    22.1 Whether any special rules are needed for double deduction/double taxation issues that arise from taxing both the company and the shareholder on their capital gains, if the double deduction/double taxation is large.

    22.2 The repeal of the qualifying company regime.

    22.3 Rules for distinguishing between available subscribed capital, capital gains that can be distributed tax free, and dividends, where a distribution is made on liquidation.

Taxation of trusts

23. The Group has made the following decisions regarding the taxation of trusts:

    23.1 Extension of the taxation of capital gains should apply to assets held by trusts in the same way as it applies to assets held by individuals.

    23.2 Distributions (other than of beneficiary income) from a complying trust would continue to be tax free to the beneficiary.

23.3 Distributions from foreign trusts would be tax free to the beneficiary only if they represented corpus, or realised capital gains to the extent arising prior to the introduction of the rules extending the taxation of capital gains.

23.4 An avoidance rule should be created to treat certain changes in a trustee (including changes in ownership of a trustee) or a trust deed as triggering a deemed disposal of the property held by the trust if the purpose of the change is to defeat the rules.

Taxation of KiwiSaver and other managed investment entities

24. The Group has made the following decisions regarding the taxation of KiwiSaver and other managed investment entities:

24.1 So far as possible, any new rules should not disturb the following features of the current rules for taxing multi-rate PIEs (MRPIEs):

24.1.1 the imposition of only one level of tax;

24.1.2 the imposition of tax at portfolio investor rates;

24.1.3 income calculated on the same basis as it would be if an individual invested directly;

24.1.4 keeping tax "outside the fund".

24.2 Distributions from listed PIEs should continue to be taxed as they are under the current rules.

25. There have not yet been any decisions made regarding:

25.1 How real property and Australasian shares held by MRPIEs should be taxed.

25.2 How sales of units in MRPIEs should be taxed.

25.3 How sales of shares in listed PIEs should be taxed.

25.4 How to tax life insurance policyholders on gains on their policies.

25.5 How to tax gains on sales of Maori authority interests.

Taxation of corporate groups

26. The Group has made the following decisions regarding the taxation of corporate groups:

For grouped companies transferring losses:

26.1 Where losses are transferred within a group of companies with 66% shareholder commonality:

26.1.1 the cost base of the shares of the company transferring the loss must be reduced by the amount of the loss transferred (however, the cost base can never be negative (ie, the reduction will be capped to an amount equal to the original cost base of the company));

26.1.2 the company receiving the benefit of the transferred loss should have the cost base of its shares increased by the amount of the loss it receives (or a the amount of the loss company's reduction if that was less);

26.1.3 this treatment should be mirrored for each company where losses are transferred up a chain of companies.

26.2 No adjustment should be made to the cost base of shares held by minority shareholders (ie, shareholders that are not part of the group) for losses transferred within a group. The full value of the loss transfer should be reflected in the cost of the majority shareholders' shares.

26.3 Loss adjustments should be made at the end of the income year, or immediately before any shares are sold during an income year.

26.4 No adjustment is necessary where losses are transferred by way of a subvention payment.

For consolidated groups:

26.5 For each year, the cost base of the shares in each consolidated group member should be:

26.5.1 the opening cost base; plus

26.5.2 contributions to capital made during the year; plus

26.5.3 taxable income of the group member as determined under the consolidated group rules; less

26.5.4 distributions of the consolidated group member made during the year; less

26.5.5 tax loss of the group member as determined under the consolidated group rules.

26.6 Changes in the cost base of shares in a consolidated group member should be mirrored up a chain of companies.

26.7 The cost base of a share in a consolidated group member cannot be negative.

26.8 Adjustments should be made at the end of the income year, or immediately before any shares are sold during an income year.

For exempt intercorporate dividends:

26.9 No adjustment is required for receipt of an imputed or unimputed dividend.

26.10 The cost base of the shares in a wholly-owned subsidiary should be reduced by the amount of a dividend paid, unless the dividend is imputed and the shareholder and the subsidiary are not members of the same imputation group.

27. There have not yet been any decisions made regarding:

27.1 The treatment of transactions within a consolidated group that are currently ignored.

27.2 Whether an adjustment should be made to the cost base of the shares of a wholly-owned subsidiary where it pays a dividend and the companies are part of the same imputation group.

Livestock and other assets

28. There have not yet been any decisions made regarding how rules extending the taxation of capital gains will apply to livestock, and in particular to livestock valued under the herd scheme.

Administrative aspects

29. There have not yet been any decisions made regarding:

    29.1 Whether withholding taxes could be imposed to assist in collecting further tax from the sale of capital assets.

    29.2 Whether change to the provisional tax regime are necessary.

    29.3 Whether contemporaneous documentation should be filed with Inland Revenue on an annual basis, itemising the cost of assets subject to the rules.

    29.4 Whether rules may be required to mitigate cash flow problems in cases of realisations that do not provide any funds to pay the tax (eg, gifts if no roll-over relief, deemed realisation on migration).