Tax Working Group Information Release

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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.

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TWG – Death as a realisation event

7 September 2108

The issue is what whether and to what extent TWG should recommend roll-over (without uplift) on death.

Suggested issues to work through

Issue 1 – we agree to roll-over where transfer is to a spouse/partner?

Arguably justified on basis that there is no in substance change in ownership on death – the spouse/partner always had an interest (albeit not legal title) to the property under the Property (Relationships) Act 1976. But arguably only 50% of the property.

Not aware of any country that does not allow this – even South Africa.

Issue 2 – Key issue it seems – should there be roll-over relief if property passes to another generation?

Arguably under the Family Protection Act 1955 children, parents and parents (second degree but not siblings) have a claim on property of a deceased person and the similar arguments re no change in substance in ownership apply as per spouse/partner. Interests under Family Protection Act 1955 contingent but so are interests under the Property (Relationships) Act 1976. Step children can have a claim under the Family Protection Act but only if being maintained or entitled to be maintained at date of death.

Policy argument for not allowing property to pass without tax to next generation is to prevent accumulations of wealth through generations. But arguably preventing this is the role of inheritance tax/estate, death and gift duty which is precluded by terms of reference.

Issue 3 – If we allow roll-over to future generations why restrict to relatives of second degree or otherwise?

Should roll-over relief apply irrespective of the relationship between the deceased and the person to whom the property is transferred? The mere fact that a person provides for someone in a will could be seen as sufficient nexus between the deceased and the transferee to justify roll over relief.

Restricting relief to second degree of relationship seems somewhat arbitrary based around nuclear family not reflective of diversity of modern New Zealand. Position of step children, great grandchildren, and wider whanau are examples.

If roll-over relief provided to non-relatives, then argument that there is no in substance change in economic ownership seems weaker although it can still be argued that the transferee had an

expectation under the will of receiving property. Obviously such an expectation is contingent (will can be changed before death) but then so is relationship property – can be spent prior to relationship break up or death. Alternatively argument for roll-over can be argued on basis that transfer of property on death does not sufficient to result in a realisation of the gain as required by a realised tax on gains. Nothing has happened except the owner has died.

Issue 4 – Should any of the above be restricted by type of property transferred?

Issue here seems to be should roll-over relief under any of the above be restricted to "illiquid assets". "Illiquid assets" seem best defined by what is to be regarded as "liquid". Seems to be: trading stock, portfolio shares and perhaps residential accommodation in the tax base (holiday homes).

If rationale for roll-over on death is no in substance change in economic ownership then difficult to see reason why this does not apply equally to liquid and illiquid property.

If rationale for roll-over on death is not sufficient realisation of the gain as required by a realised tax on gains, then greater argument for restricting relief to illiquid property.

Need to consider issues of complexity and incentive to hold illiquid versus liquid assets.

Issue 5 - Roll-over on death rules should be consistent.

Means – roll-over relief for gains should apply for all assets, replacing current law – see annex for current law. Means if we limit roll-over to say spouse/partner then repeal wider rules above and are more restrictive. If we have less restrictive roll-over then that would apply replacing current law with less restrictive provisions. That means if we have no roll-over relief or relief only for property transferred to spouse/partner rules would be more restrictive than current law. If we have unrestricted roll-over relief then rules would be less restrictive than current law except re forestry.

Issue 6 – Consistency with treatment of gifts

Seems to be agreed that where there is roll-over on death there should also be roll-over on gifting. This means restrictive roll-over on death would mean taxing gains on the gifting of property.

Implications of a restrictive approach to roll-over on death

Maori interests

A decision on extent of roll-over relief on death has significant implications for Maori assets – interests in Maori land and Maori authorities. Our general assumption is that these assets are seldom sold so limited impact of taxing gains. However, clearly they are transferred on death. No or restrictive roll-over on death would seem to result in gains on these assets being taxed.

Trusts

The main policy objective of restrictive roll-over on death seems to be to prevent intra-generational transfer of assets without imposing tax on gains. Assets can in effect be transferred between generations by the use of trusts (settling assets on trust for future generations). Thus if a restrictive

approach to roll-over on death is adopted then consideration would seem to need to be given to trust busting measures as set out in paragraphs 130 to 149 of Appendix B of the clean version of the draft interim report. Presumably this should apply only to the extent that the trust property once distributed would not have (or might not have) had roll-over relief if it passed to the beneficiary on death of the settlor.

These rules would likely be complex and have not yet properly been considered by the Group.

The Need for Market Value Rules

If a restrictive approach to roll-over on death is adopted, as noted above non-charitable gifts will be subject to tax gains in the hands of the transferor. The transferor would be deemed to have sold any gifted asset for its market value. Where an asset is simply gifted this seems to follow normal rules. Property may however be sold but for less than market value. This then requires domestic transfer pricing rules to ensure that any gain that is gifted is taxed. Consideration would also need to be given to property sold for say deferred consideration – sold for market value but payment in 100 years' time with no or below market interest. Where the market value rule produces a loss for the transferor (market value less than the transferor's cost basis) then consideration needs to be given to whether this is a deductible loss.

A non-restrictive approach seems to avoid these complications. If property is gifted, the transferor is deemed to have sold at its cost basis. The transferee adopts the transferor's cost basis. If it is sold below market value, the transfer is deemed to take place at the higher of the transferor's cost basis or the sale price (with the transferor taxed on any gain being the difference between costs base and transfer value). Only where property is sold for consideration resulting in a loss for the transferor does consideration need to be given to whether the sale price was at market value (in effect to disallow a deductible loss where the loss arises from a sale below market value).

Other Points to Note

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- Most other countries seem to provide largely unrestricted roll-over on death. See my note of 6 June. Many provide roll-over with uplift although that may relate to them also having death duty.
- Labour's policy "Fairer Tax System" 2011: Capital gains on inheritance passed on after death will be rolled over to the heir, and not payable until the asset is sold. This follows the Australian example." Also "Maori customary land passes upon death to the subsequent generation and is not normally sold. The rollover on death provisions mean no CGT is payable."

Robin Oliver

Annex Current NZ law

Our general rule is that income is calculated as at date of death of the deceased. Thereafter assets are transferred at market value to the administrator or executor with income then being that of the estate. Assets are then transferred at market value to the beneficiary.

There is however roll-over relief with uplift with respect to revenue account property (including financial arrangements and FIFs, trading stock, standing timber, or land that is taxed on gains) transferred to a spouse/partner or to relatives to the second degree or charities. This covers both the transfer of property to the estate and from the estate to the beneficiary. Depreciable property can be treated this way electively (so that the acquirer can take new cost base for depreciation but depreciation recovery will apply re the estate).

Current rules seem complex and I find it hard to discern a coherent policy framework underlining them.

In more detail roll-over relief applies to revenue account property on death and then distribution be the estate where

- Transferred to spouse/partner but not if non relative (second degree) is entitles to any such property (FC 3).
- Transferred to spouse/partner or relative (second degree) provided a "simple estate" – only such people plus charity are the beneficiaries, no life interest, all income distributed by the estate as soon as possible (FC 4).
- Land dealer, developer or builder is the deceased and land gains taxed subject to 10 Year rule then if transferred to spouse/partner or relative (second degree) then only taxable (with roll-over) if sold within 10 years deceased purchased the land FC 5.
- Forestry is transferred to spouse/partner or relative (second degree). No restrictions as above (FC 6).