Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

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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.

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Coversheet: **ETCI: Rollover treatment**

Position Paper for Session 20 of the Tax Working Group
12 October 2018

Purpose of discussion

The purpose of this paper is to propose principles on which rollover treatment for any proposed extension to the taxation of capital income ("ETCI") should be based, and explains the link between rollover and loss-ring fencing. The paper also illustrates how the proposed principles can be applied to various situations. It does not suggest wording for the final report because of the complexity of the issues involved. Final text will be drafted after key issues have been discussed and resolved.

The recommendations in this paper are 'in principle' recommendations, as they have been made without considering the fiscal impacts of the design features. The Secretariat is currently modelling fiscal impacts of design choices to the extent practicable, and will report back to the Group at a later date. The Group may revisit any design choices in light of those fiscals.

Key points for discussion

This paper:

a. Discusses how rollover treatment would have significant impacts on the fairness, integrity, revenue, and efficiency benefits of an ETCI, and the administrative complexity, compliance and efficiency costs.

b. Discusses the link between rollover treatment and loss ring-fencing.

c. Discusses rollover treatment for transfers where there is no change in ownership in substance of the assets.

d. Discusses rollover treatment for involuntary events.

e. Discusses rollover treatment for voluntary sales and reinvestment.

f. Discusses rollover treatment for death and gifting events.

g. Discusses rollover treatment for relationship property divisions.

h. Discusses how rollover treatment would affect transfers of Māori assets.

Recommended actions

We recommend, in principle, that you:

General

a. **note** that rollover treatment reduces the revenue raised from the tax, as it allows the tax to be deferred until there is a realisation event that does not qualify for rollover. This could be in many years' time or potentially many lifetimes, if rollover treatment applies to death and gifts.

b. **note** that some forms of rollover treatment may negate the fairness benefits that ETCI is intended to provide.

c. **note** that where rollover treatment reduces "lock-in" for an initial realisation event, it will lead to greater "lock-in" issues in the long term and may bias decisions on how firms reinvest.

d. **note** there are three main reasons for taxing the capital gain at the time an asset is actually sold (on realisation, as opposed to when the gains accrue):

   i. there is an ability to pay the tax from the sale proceeds.

   ii. there is accurate measurement of the gain based on the sale price.

   iii. the decision to sell is within the taxpayer's control.

e. **agree** that the same reasons should be considered when evaluating which situations should qualify for rollover treatment.

No change in ownership in substance

f. **agree** in principle that, provided integrity risks are addressed, rollover treatment should apply to transfers of business assets that do not change the ownership in substance, including:

   i. incorporation by a sole trader or partnership where the vendor does not receive any consideration for the transfer, other than an ownership interest in the transferee;

   ii. transfers within a wholly-owned group; and

   iii. de-mergers.

Certain involuntary events

g. **agree** that rollover treatment should apply to compulsory acquisition of land by the Crown.

h. **agree** that rollover treatment should apply to insurance proceeds or other compensation for assets destroyed by natural disaster or similar events.

i. **agree** that rollover treatment for the involuntary events (in g. and h. above) should only apply if the asset owner uses the proceeds to acquire a similar replacement asset.

Voluntary sales and reinvestment

j. **note** that if rollover was provided for voluntary events it is likely to require some level of loss ring-fencing to protect the integrity of the tax system.

k. **agree** that rollover should **not** be provided to voluntary disposals and reacquisitions involving:

    i. business premises;

    ii. capital assets that are replaced by a "similar" asset that is used within the same business; or

    iii. any capital business asset (including where the new asset is a different type of asset or business).

Death and gifting events

l. **note** that providing rollover on death and gifting is likely to reduce the vertical equity (progressivity) of the tax.

m. **note** that there is a stronger case for rollover of transfers on death than for gifts during a person's life.

n. **note** that if rollover is allowed for transfers on death but not for gifts, there would be an incentive for taxpayers to hold assets until they die (which could be inefficient).

o. **note** that if rollover is allowed for gifts during a person's life, it would need to override the associated persons rules and potentially create avoidance opportunities.

p. **note** there is a stronger case for providing rollover treatment for certain "illiquid" assets which are difficult to value and harder to sell or borrow against than other assets.

q. **agree** that the "illiquid assets" that qualify for rollover treatment could be:

    i. shares, land (including farmland) and other assets in active unlisted companies and unincorporated businesses; and

    ii. land whose legal nature means it is very difficult to sell or use as security for a loan (e.g. interests in Māori freehold land).

r. **agree** that rollover should be provided for all transfers of qualifying illiquid assets on death (regardless of the deceased person's relationship with the recipient).

s. **agree** that rollover should only be provided for transfers of other assets (i.e. assets that are not qualifying illiquid assets) to a surviving spouse, civil union or de facto partner on death.

t. **agree** that rollover should **not** be provided for gifts of illiquid assets.

u. **agree** that rollover should **not** be provided for gifts of other non-qualifying assets.

v. **agree** that, where the terms of the trust are such that rollover would necessarily apply if a taxable asset had instead moved directly from the settlor to the trust beneficiaries, rollover should also apply to both the settlement into and distribution out of the trust.

w. **agree** that rules should ensure that trusts cannot be used to avoid what would otherwise be realisations.

x. **agree** that the tax treatment of transfers on death and gifts should apply equally to revenue account property and taxable capital assets.

y. **agree** that if rollover is provided for gifts this should be limited to cases where the gift is made and received by a natural person, and possibly family trusts or certain Māori entities, in order to reduce avoidance risks.

z. **agree** that rollover should not be allowed for gifts or transfers on death to non-residents in those cases where New Zealand would lose the right to tax the gain because the asset is held by a non-resident.

<u>Relationship property divisions</u>

aa. **agree** that rollover treatment should apply to transfers of property when a marriage, civil union or de facto relationship is dissolved on separation.

<u>Māori collectively-owned assets</u>

bb. **note** that recommended rollover for transfers of business assets that do not change the ownership in substance will provide rollover for some, but not all, reorganisations of iwi settlement assets, so further rollover may need to be considered.

cc. **note** that rollover treatment could be developed to ensure the tax does not create undue obstacles to iwi regaining control of ancestral land. We will report with recommendations on this following consultation.

dd. **note** that Māori freehold land would be a qualifying illiquid asset for the purposes of any proposed rollover provided for qualifying illiquid assets.

ee. **note** that issues surrounding Māori collectively held assets will be further explored on consultation and reported back.

<u>Other</u>

ff. **consider** next steps and, in particular, whether decisions made on rollover treatment mean that any other elements of the ETCI reform should be revisited.

gg. **note** that the Group may have to reconsider some of its recommendations after it has received models of the fiscal impacts of the design features.

Rollover treatment and Loss ring-fencing

Decision Paper for Session 20
of the Tax Working Group

October 2018

Prepared by Inland Revenue and the Treasury

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1. Introduction

1.1 Purpose

1. The purpose of this paper is to provide the Group with further information and analysis to assist with the Group's decisions regarding situations where rollover treatment should apply and, in particular, the implications for loss ring-fencing.

1.2 What is rollover treatment?

2. Rollover treatment provides an exception to applying tax to capital gains when a realisation event such as a sale or transfer of the asset (including a bequest or gift) has occurred.

3. It does not mean the gain or loss is never taxed. It means taxation of the gain or loss is deferred until there is a later realisation event which is not eligible for rollover treatment.

Example 1– Rollover treatment

A buys a holiday home for $500,000. When A dies, she leaves the holiday home, worth $700,000, to her children. The children sell it 5 years later for $950,000.

If the transfer of the holiday home to A's children is treated as a realisation event which is **not** eligible for rollover treatment:
- A will have $200,000 of taxable income at the time of her death, which will be returned by her executor/administrator.
- A's children will have taxable income of $250,000 when they sell the holiday home 5 years later.

If the transfer is eligible for rollover treatment:
- A will be treated as having no taxable income from the holiday home on her death.
- A's children will have taxable income of $450,000 when they sell the holiday home 5 years later.

4. In other countries, rollover treatment may apply to some events that are within the control of the taxpayer (e.g. where business premises are sold and the proceeds are reinvested into a new business premises). In these cases, taxpayers can "cherry-pick" to take advantage of the differing tax treatment of capital gains and losses. They can use the rollover treatment to shelter tax on gains when assets have appreciated, while generating tax losses by not applying the treatment when the assets have depreciated. This asymmetry creates revenue integrity and efficiency concerns.

5. Therefore, the more extensive the rollover treatment, the more likely it is that extensive loss ring-fencing rules will be required to mitigate the fiscal risks created by this ability to "cherry-pick" by deferring tax on gains while realising tax losses.

1.3 What is loss ring-fencing?

6. Loss ring-fencing is a special tax rule whereby a particular type of loss can only be offset against a particular type of income (usually of a similar character).

7. This means there is a trade-off between the extent of rollover treatment provided (in situations which are within the taxpayer's control), and the economic and compliance costs as a result of the extent of loss ring-fencing required.

Example 2 – Rollover treatment and loss ring-fencing

A company has business profits of $2m in the current year. It also owns two commercial buildings, one which has appreciated in value by $1m and the other which has depreciated by $2m (assume no tax depreciation has been allowed). The company sells both buildings. The tax treatment under three different tax settings would be as follows.

<u>No rollover treatment and no loss ring-fencing</u>:
The company would be taxed on $2m of business profits and the $1m gain from the appreciated building. The company would derive a $2m tax loss on the other building, so they it would have $1m of net income and pay $280,000 of tax. This income tax treatment outcome is closest to taxing economic income.

<u>Rollover treatment, no ring-fencing:</u>
If the company is able to claim rollover treatment for the appreciated building (e.g. because they buy a similar replacement building), it will not be taxed on the gain on the appreciated building until a later point. It can also use the $2m tax loss from the depreciated building to fully offset the tax on their $2m business profits, so will pay no tax. This income tax treatment exposes the Government to fiscal risk from taxpayers accelerating deductible capital losses and using rollover treatment to defer taxation of capital gains.

<u>Rollover treatment with ring-fencing:</u>
If capital losses on buildings were ring-fenced, the company would have $2m of net income in the current year (being $2m business profits only), on which they pay tax of $560,000. The $1m gain on the appreciated building can be offset against $1m of the $2m loss from the depreciated building. The remaining $1m loss will be carried forward and may be used against future capital gains from buildings.

Using loss ring-fencing rules to mitigate the tax integrity concern created by some taxpayers taking advantage of rollover treatment to minimise their tax will give rise to an unfair and inefficient outcome for other taxpayers. In this example, the company is overtaxed relative to its economic income, because the ring-fencing lowers the value of its loss.

2. How do rollover treatment and loss ring-fencing affect delivery of the overall objectives of the tax?

2.1 Objectives of extending taxation to capital income

8. The Group noted it needs to consider if the *fairness*, *integrity*, *revenue*, and *efficiency* benefits from reform outweigh the *administrative complexity*, *compliance costs*, and *efficiency* costs that arise from the proposed additional capital income taxation.

9. ETCI improves *fairness* through:

   - **Horizontal equity**. It taxes income whether it is earned through capital gains or otherwise. This is a big issue as capital gains can be an important source of income for many. For example, we have seen previously that untaxed realised gains are 20% of accounting profits for SMEs. Untaxed realised gains are approximately 17% of net taxable income for "significant enterprises" (companies with revenue of over $80m per annum).

   - **Vertical equity** (progressivity). Higher wealth individuals and households tend to derive a greater proportion of their income from increases in values of capital assets than lower wealth individuals and households. The Group has received estimates from the Treasury that, in New Zealand, 82% of assets potentially affected by an extension of the taxation of capital income are held by the top 20% of households by wealth. We have also seen that more than one-third of the wealth of most high-wealth individuals has been built up in ways that have not been taxed and the lack of a tax on realised gains is likely a major contributor to this.

Example 3 – Horizontal equity

There are three individuals: Anna, Barry, and Carl.

- Anna is retired and has $400,000 in a term deposit, earning 5% interest. Her income is $20,000 and it is all taxed.
- Barry owns a rental property worth $400,000. The taxable rental income is 3% and he derives a 2% capital gain. His total income is $20,000, but only $12,000 is taxed.
- Carl works 20 hours a week for $20 an hour. His yearly income is $20,000 and it is all taxed.

In all three of these situations the economic income of Anna, Barry, and Carl is $20,000, but because some of Barry's income is a capital gain it is untaxed. This violates horizontal equity.

10. Taxing capital gains is aimed at reducing this horizontal inequity. It also promotes vertical equity because capital gains are a major part of the income of the well-off.

11. It also improves *integrity* by reducing the scope for differences between the company rate and the top personal rate to shelter income from higher rates of personal tax.

12. It increases *revenue* and in so doing, creates a means of financing tax cuts or spending measures which can address other government priorities.

13. It improves *efficiency* through reducing tax-driven incentives to make investments in assets that produce capital gains rather than other income.

14. Whether these benefits outweigh the administrative complexity, compliance costs and efficiency costs that arise from the tax depends on the design of the tax, including key features such as whether to tax on realisation and the circumstances in which rollover treatment and loss ring-fencing apply.

15. In designing rollover treatment, the Secretariat suggests that the Group try to maximise the benefits of the tax while minimising the costs. To that end, it suggests rollover treatment that helps support the fairness, integrity, revenue, and efficiency benefits, and minimises the administrative complexity, compliance and efficiency costs.

2.2 Disadvantages from applying tax on realisation

16. In the Interim Report the Group proposed that the tax should be imposed on realisation rather than on accrual in most cases. This means the tax would not typically apply as gains accumulate (e.g. when an asset owner simply holds an appreciating asset) but will instead apply when the gains are realised (the most obvious case being where the asset owner sells their asset to a third party).

17. There are three key disadvantages that arise from applying tax on realisation (rather than as gains accrue):

    a. **Potential for long-term deferral of tax**. This undermines fairness (both horizontal and vertical equity) and neutrality with other income which is usually taxed much more frequently and consistently due to being earned as a regular income stream.

    b. **"Lock-in" incentives**. Owners of assets are encouraged to retain them rather than sell them, because selling triggers a tax liability, even though in the absence of tax, selling the asset would be more economically efficient than retaining it.

    c. **Some realisation events may be outside owner's control**. This may be seen as unfair from a horizontal equity perspective as other asset owners will only pay tax if they choose to sell.

18. Rollover treatment aims to mitigate the "lock-in" and horizontal equity issues noted in points (b) and (c). However, it does so by further prolonging tax deferral which exacerbates the fairness and neutrality problems described in point (a). Extending tax deferral also increases "lock-in" incentives by increasing the amount of tax that must be paid if a taxpayer triggers a realisation event. Rollover treatment can also bias decisions on how reinvestment takes place.

19. The general impacts of providing rollover treatment on the fairness, efficiency, simplicity and revenue integrity of the tax are further discussed below.

20. It is important to emphasise that the views in this Chapter are general views and the actual impacts will depend on the design of each type of rollover treatment provided (and the design of any associated loss-ring fencing rules).

2.3 General impacts from providing rollover treatment

Fairness

21. As rollover treatment reduces the circumstances in which an extension of taxation on capital income applies, it also reduces the vertical equity and horizontal equity benefits.

Horizontal equity

22. Horizontal equity suggests that people in similar situations should face similar tax outcomes.

23. There are two dimensions to horizontal equity in the case of rollover treatment. From the perspective of income generally, rollover treatment is inconsistent with horizontal equity as it further defers the taxation of income, while for those who earn income in ways other than capital gains, there is no such benefit. The deferral impact is illustrated in Example 4 below which considers the after-tax position for taxpayers Bill and Claire.

Example 4 – deferral impact of rollover

Bill and Claire are both taxed at a rate of 33%. Bill deposits $1,000 in an interest-bearing account earning a compounding 5% per annum of interest for 10 years. Claire instead invests $1,000 in a block of land which appreciates at 5% per annum and is sold after 10 years.

The Table below shows that at present with no tax on capital gains Bill would accumulate $1,390 whereas Claire would accumulate $1,629 after 10 years. Thus Claire ends up being 17.2% better off after 10 years. This violates horizontal equity. Bringing in a tax on realised gains would mean that Claire would end up with $1,421 after 10 years. This still makes her somewhat better off than Bill because interest is taxed each year as it accumulates whereas capital gains are taxed only on realisation. But now Claire is only be 2.2% better off than Bill so this gain is slight. Thus, if income is accumulating for short periods, taxing realised gains substantially addresses horizontal inequities.

Years income accumulates	Bill's accumulated interest	Claire's land (no tax on capital gains)	Claire's gain relative to Bill	Claire's land (tax on realised capital gains)	Claire's gain relative to Bill
10	1,390	1,629	**17.2%**	1,421	**2.2%**
20	1,933	2,108	**37.2%**	2,108	**9.1%**
40	3,736	5,047	**88.4%**	5,047	**35.1%**

The timing benefits of gains being taxed only when they are realised increases the longer that assets are held. For example, if assets were held for 40 years and capital gains were taxed on realisation, Claire would be 35.1% better off than Bill. Rollover treatment defers the time when gains are realised for the purposes of an ETCI. To that extent it reduces the benefits of a capital gains tax in reducing horizontal inequities.

24. There is, however, a second horizontal equity perspective. This is that, for two taxpayers who own capital assets, there can be important horizontal equity concerns that justify rollover treatment. Perhaps the clearest case is for realisation events that are outside the taxpayer's control, as this ensures equal treatment with other asset owners who only have to pay the tax if they make a decision to sell. These events could include a compulsory acquisition by the Crown, destruction or loss of an asset giving rise to insurance proceeds or divorces.

25. Horizontal equity considerations also mean that if rollover treatment applies to a wide range of situations, or in the absence of clear principles, it may be hard to justify not extending rollover to other cases (e.g. due to lobbying from groups facing comparable situations that are not entitled to rollover treatment). This is particularly true if there are not obvious principles for why the rollover treatment was provided.

Vertical equity

26. A key objective of the tax is to increase the fairness and progressivity of the tax system by taxing gains that are currently untaxed on appreciating assets such as land or shares. These assets are more likely to be owned by wealthy people and the gains on those assets often represent a significant share of a wealthy person's economic income.

27. Rollover treatment can undermine this objective as it enables asset owners to defer paying the tax for a longer time period. The ability to defer payment of tax does not exist for most other forms of income (e.g. salary and wages, interest).

28. Furthermore, depending on the design of the rollover treatment, wealthier people may be better able to utilise rollover. This is because they may be more able to reinvest into replacement assets (as opposed to needing the funds to meet other expenses) or more likely to inherit or gift assets. They may also have better access to tax advice on how to best use the rollover provisions so as to minimise their tax liabilities.

29. In contrast, less wealthy people are more likely to need to sell their assets in a way that does not qualify for rollover treatment. They are therefore more likely to be required to pay the tax.

Example 5 – Vertical equity

Donna has saved $35,000 for her retirement, which is kept in a term deposit with a bank in case she needs it to supplement her NZ Superannuation. Over the years, the accumulated after-tax interest on the term deposit is $25,000. She is taxed on the interest as it is paid to her account.

Eugene has saved $300,000 for his retirement, which he has invested in New Zealand listed shares. Over the years, the shares have accumulated capital gains of $500,000 which have not been taxed.

Donna and Eugene both die and pass their savings on to their children.

The accumulated $25,000 of interest that Donna derived and passes on has been fully taxed, so it does not matter to her or her heirs if rollover treatment applies on death.

In contrast, the $500,000 of capital gains that Eugene derived has not been taxed. If rollover treatment applies on death, these gains will not be taxed unless Eugene's heirs sell the shares.

If there is rollover treatment on death, Eugene will be able to pass the New Zealand listed shares to his children with no capital gains having been taxed. If Donna is able to pass any of her $60,000 on to her children, the entire income will have been taxed.

Efficiency

30. Rollover treatment will minimise some biases on investment decisions to ensure businesses and investors do not base their decisions on tax inconsistencies, but make the same decision in a world with tax as they would make in a world without tax.

31. As noted above, a key disadvantage created by taxing on realisation is "lock-in" effects. Rollover treatment can reduce "lock-in" and other investment biases for the initial realisation event (which increases efficiency) but leads to greater "lock-in" issues in the long term. This is because it increases the potential tax liability that would apply if the asset owner eventually decides to sell (which reduces efficiency).

Example 6 – Short-term and long-term lock-in

It is 2032 and Ariana is a farmer with farmland that was purchased for $4m in 2022.

Short-term lock-in

The land is currently worth $6m. Ariana wants to increase the size of her farm but surrounding land is not for sale. Ariana finds a larger farm for sale nearby for $7m.

If Ariana sells her current land and receives rollover treatment, she will have to borrow an additional $1m from the bank. If she does not receive rollover treatment she will have to borrow $1.56m (the $560,000 representing company tax on the capital gain of $2m). Selling her initial farm now rather than in the future brings forward the time when her gain is taxed and increases the present value of the taxes that she pays. Without rollover treatment Ariana faces a "lock-in" incentive to keep her smaller farm.

Long-term lock-in

Assume Ariana sold her land in 2032 for $6m and bought the $7m farm. It is now 2042 and Ariana is thinking about moving out of farming and buying a commercial property in town. Her farmland is now worth $9m. If rollover treatment was provided on the farmland sold in 2032, tax on her gain will be $1.4m (28% of $5m gain) and net proceeds will be $7.6m.

If rollover treatment was not provided in 2032, the tax in 2042 will be $560,000 (28% of $2m gain). She will have to find an investment that matches her farm income (where the farm is valued at $9m) with $8.44m of proceeds, instead of $7.6m if there had been rollover. In this case the lock-in incentive is less than had rollover treatment been provided in 2032.

32. While rollover treatment can alleviate short-term lock-in, it exacerbates long-term lock-in. It is not clear which is more economically harmful and the Secretariat is of the view that it should be considered an open question whether economic efficiency supports rollover treatment.

33. Rollover treatment for voluntary sale proceeds that are reinvested into replacement assets can also create "lock-in" into an asset class if rollover is limited to reinvestment in "similar assets".

Example 7 – Similar asset lock-in

Productivity Co. has created an income earning asset (Asset A) by spending $100. The asset is expected to earn $10 per year in perpetuity, and because the prevailing interest rate is 5% it is valued at $200. The result is that Productivity Co. has an unrealised $100 capital gain. Assume a 28% tax rate.

Productivity Co. sees a $200 asset that it knows can earn it $11 per year in perpetuity when it is supported by its sales team. It is a similar asset to Asset A.

Without rollover treatment Productivity Co. will not make the productivity enhancing sale of Asset A and purchase of Asset B. The present value of the additional income stream would be $20 but the tax cost would be $28. This example might support rollover treatment for similar "replacement assets".

But now imagine that there is Asset C (also for $200) that is not similar to assets A and B and it that will earn $12 per year. This the most productive asset for Productivity Co. to own of all.

If there is "replacement asset" rollover treatment for similar assets, Productivity Co. will see Asset B as a worthwhile purchase but not Asset C. The irony is that without "replacement asset" rollover treatment, Productivity Co. would sell Asset A and purchase Asset C, but rollover treatment has incentivised a less productive purchase.

The table below sets out the different outcomes under either regime. The most profitable investment is highlighted and in bold.

		Net proceeds if sold	**Interest on borrowings from bank to fund new asset**	**Revenue from (new) investment**	**Profit**
Similar "replacement asset" rollover	**Asset A**	-	$0	$10	$10
	Asset B	**$200**	**$0**	**$11**	**$11**
	Asset C	$172	$1.40	$12	$10.60
No rollover	**Asset A**	-	$0	$10	$10
	Asset B	$172	$1.40	$11	$9.40
	Asset C	**$172**	**$1.40**	**$12**	**$10.60**

34. The example above suggests that the efficiency effects of rollover treatment are uncertain. On the one hand it may promote efficiency by reducing a barrier in the way of a taxpayer trading up to a more productive asset than is currently being used. At the same time, rollover treatment can reduce efficiency by creating longer term lock-in and also by encouraging taxpayers to reinvest in similar assets when changing assets might be more productive.

Simplicity

35. Targeting rollover treatment at particular assets or circumstances increases complexity and compliance costs by making it less certain what qualifies for rollover.

Revenue impact and integrity

36. Rollover treatment defers and potentially reduces the revenue raised from the tax, as it allows the tax to be deferred until there is a realisation event that does not qualify for rollover. This could be in many years' time or potentially many lifetimes, if rollover treatment applies to death and gifts.

37. The fiscal cost of rollover treatment is hard to estimate, but there is some data from the United States. The data for individuals is the most detailed and provides the best information available. The table below compares the value of rollover treatment provided for individuals who utilise the United States "like-kind" exchange rollover rules reinvested in similar replacements assets in 2011 against total *net* capital gains from these assets. These are similar to the rollover rules for replacement assets outlined in Chapter 6 of this paper, but differ in the detail of the rules.

	Business real estate	**Rental real estate**	**Farmland**	**Other land**	**Total** (for previous 4 categories)
Like kind rollover	1,040	922	410	280	**2,652**
Total net gains	5,034	1,968	2,755	5,018	**14,775**
Proportion rolled over	17.1%	31.9%	13.0%	5.3%	**15.2%**

Source: IRS Tax Statistics (https://www.irs.gov/statistics/soi-tax-stats-sales-of-capital-assets-reported-on-individual-tax-returns
Recent Trends in Like-kind Exchanges (2017) Gerald Auten, Office of Tax Analysis, U.S. Department of the Treasury, David Joulfaian, Office of Tax Analysis, U.S. Department of the Treasury, Romen Mookerjee, Dartmouth University
Secretariat calculations

38. Rollover treatment, if not accompanied by extensive loss ring-fencing, will create opportunities to shelter gains from tax by enabling some taxpayers to "cherry-pick" by deferring gains and realising losses.

2.4 Flow-on impacts from loss ring-fencing rules

39. To mitigate "cherry-picking" and other integrity concerns from rollover treatment, additional loss ring-fencing rules are likely to be required. Loss ring-fencing rules have negative impacts on fairness, efficiency and simplicity.

Fairness

40. Loss ring-fencing rules reduce fairness because they apply to investors who have genuine losses. They therefore apply more broadly than the target group which is taking advantage of the tax rules by artificially accelerating their tax losses and deferring tax on their capital gains. These taxpayers are worse off compared to

taxpayers who have losses that they can offset against other income. In particular, wealthier taxpayers (including those who may be taking advantage of rollover treatment and other deferral mechanisms) are likely to have a bigger portfolio of assets on which they can utilise their losses to offset income (even if the losses are ring-fenced to a particular asset) so will be less impacted by loss ring-fencing than poorer taxpayers with fewer assets.

Efficiency

41. Loss ring-fencing creates a bias against risky investments that may generate capital gains or losses. This will create a tax bias which will discourage investment in some activities that would have been attractive with more neutral tax settings. It will discourage investment in some assets with high expected returns. This will tend to, at the margin, reduce the productivity of investments in New Zealand.

Example 8 – bias against risky investments

An investor has the choice of investing $100 in two different ways:

Option A:	Fixed return of $5 in a year's time
Option B:	50% chance of a $30 gain and a 50% chance of $10 loss in a year's time

Option B is more risky but has a higher expected value or average return of $10 (being 0.5*30 – 0.5*10). In the absence of tax, the investor might choose Option B if they judged the extra return worth the risk.

However if losses are ring-fenced, the tax system may make Option A more attractive if the taxpayer is unable to use the losses to offset tax on their other income (the losses become harder to use and therefore less valuable).

Simplicity

42. Loss ring-fencing rules increase the complexity and compliance costs associated with the tax.

43. If extensive loss ring-fencing were required such that capital losses could only be offset against capital gains, the capital–revenue boundary will need to be maintained. This effectively removes one of the key simplicity and economic neutrality benefits from designing a tax that applies to capital gains and other forms of income in broadly the same way (e.g. at the same rates).

2.5 Concluding comments

44. Decisions on rollover treatment and loss ring-fencing will affect the economic effects of an ETCI reform. All countries that have taxes on capital gains have some forms of rollover treatment which address concerns about situations where taxes on capital gains may be particularly problematic. At the same time a sufficiently broad set of rollover treatments could significantly reduce an ETCI's capacity to deliver its key objectives.

45. In subsequent chapters we suggest a number of criteria to help make decisions on rollover treatment. In so doing we are considering a number of possible decisions one at a time. At the end of the decision making process it will, however, be critically important to stand back and consider whether the set of decisions made end up supporting or hindering the government in delivering on the key objectives of ETCI.

46. It may also be worthwhile exploring whether there are implications here for other decisions that have been made. For example, the TWG has decided to tax gains and losses at full marginal rates. A major benefit of doing so is that this removes any need to distinguish capital gains from revenue gains. This has important fairness and simplicity benefits. The simplicity benefits would, however, be negated if there were to be widespread loss ring-fencing provisions as this would require ongoing distinctions between capital and revenue gains.

3. Principles for applying rollover treatment

47. As explained above, rollover treatment can undermine some of the objectives of extending the taxation of capital income. This chapter attempts to define some key principles to identify situations where rollover treatment is most justified and is likely to maximise the benefits and minimise the costs. As the Group noted in the Interim Report:

> Without such principles, ad hoc roll-overs will be adopted, reflecting political responses to lobbying, rather than sensible tax policy.

48. As an initial point, the Secretariat suggests that, as with GST, starting from a system with limited concessions is more likely to create a dynamic where there is a high hurdle that needs to be met before more concessions proliferate. If there is extensive rollover treatment, it becomes more difficult to find strong principles to protect the fairness, integrity, and revenue potential of the tax. Widespread rollover treatment may also negate many of the fairness benefits that ETCI is intended to provide.

49. The Group's Interim Report set out two principles for when rollover treatment would seem to be justified (paragraph 40 of Appendix B):

> - When there has been no change in ownership in substance; and
> - When there has been a legal change in ownership (and a change in substance) but the nature of the transaction is such that it has not given rise to a gain that can be said to have "come home" to the vendor. … This can be contrasted with a market value sale to an unrelated party, crystallising certain gains available to the vendor to use at their discretion (including on consumption); a clear gain has "come home".

50. The rationale underpinning these two principles is further discussed below.

3.1 No change in ownership in substance

51. Rollover may be justified in cases where there has been no change in ownership in substance for the following reasons:

- There is less ability to pay a tax as often no consideration will be paid.
- Measurement of any gain/loss may be inaccurate as the price may be a non-market price.
- Imposing tax could create "lock-in" issues whereby the tax discourages the asset owners from carrying out otherwise efficient business restructuring.
- If there is no rollover treatment in these situations, the tax system is likely to have undesirable traps for the unwary and encourage business owners to be adopting tax structures now to minimise possible taxing events in the future.
- Related party sales could be used to crystallise tax losses on depreciated assets. Note that to address this problem, rollover treatment would have to be mandatory in these circumstances.

Example 9 – Rollover treatment for no change in ownership in substance

A sole trader mechanic purchased their business premises for $200,000, which has now increased in value to $500,000. The sole trader wants to incorporate and transfer the business premises to the new company. Assume there is no tax depreciation.

If there is no rollover treatment, the mechanic will trigger a tax liability on the $300,000 gain when premises are transferred to the company.

If rollover applied, the transfer would not trigger any tax liability and the company would assume the mechanic's cost base in the premises of $200,000. So if the company subsequently sells the premises to a third party for, say, $800,000, the company would be taxed on a $600,000 taxable gain. Similarly, the mechanic would have a cost base in their shares of $200,000, and a sale of those shares to a third party for $800,000 would also give rise to a taxable gain.

3.2 The relevant gain has not "come home"

52. This principle can be interpreted narrowly or broadly.

53. Under a *narrow* interpretation it would only apply when the realisation event is outside the asset owner's control and the asset owner uses the proceeds from the realisation to put themselves in broadly the same position they were in before. For example, this could include compulsory acquisition by the Crown or destruction or loss of an asset giving rise to insurance proceeds that are then used to replace the compulsorily acquired or destroyed asset. Applying tax in these cases could be considered unfair in terms of horizontal equity as other asset owners will only pay tax if they choose to sell.

Example 10 – Realisation outside asset owner's control

A taxpayer owns a hotel building which is torn down following earthquake damage. The building is insured for replacement cost. The insurance company pays the building owner insurance proceeds of $3m which is greater than the taxpayer's initial $1m cost of the building. The taxpayer uses the proceeds to acquire a similar replacement building for $3m.

If there is no rollover, the taxpayer would be taxed on a $2m gain.

If rollover treatment applied, the taxpayer would not be taxed on receipt of the insurance proceeds. However, the replacement building would assume the original building's cost base of $1m, so if the taxpayer subsequently sold the replacement building for $5m they would be taxed a gain of $4m.

54. Under a *broad* interpretation, the "come home" principle could also apply when a taxpayer has sold an asset and reinvested the proceeds into a similar replacement asset. In this case the gain arguably has not "come home" to the taxpayer because the taxpayer has reinvested the sale proceeds and has not consumed their gain. Rollover treatment in this situation is intended to reduce, in the short term, the "lock-in" biases that may otherwise discourage taxpayers from selling assets that have appreciated in value and reinvesting the proceeds in new assets which may allow them to run their business more efficiently.

55. The counter argument to this broad interpretation is that when a person decides to sell an asset for full consideration, that person clearly has a choice as to whether and how they reinvest the proceeds. At that point it is difficult to say that the gain has not "come home".

56. The fact that the "come home" principle can be interpreted either narrowly or broadly shows it is quite subjective.

57. The Secretariat considers it would be useful if the Group further clarified this principle by referring back to the reasons why it was decided that gains should be taxed on realisation instead of on accrual. The Group's Interim Report noted the following disadvantages of taxing gains on accrual:

> • **Valuation challenges.** An accrual-based tax requires a valuation at the end of each period to identify the gain or loss. Valuations are readily available for widely-traded assets, but it is difficult to impartially value some types of assets (such as closely-held businesses). These valuation challenges will impose much higher compliance costs on the owners of certain types of assets. …
>
> • **Cash flow pressures**. An accrual-based tax can create cash flow pressures for the owners of assets that do not produce regular streams of cash income. Some owners may even have to dispose of their assets to meet the tax liabilities. The risk of forced disposal could discourage investment in assets with upfront expenses but longer-term returns.
>
> • **Perceptions of unfairness.** An accrual-based tax taxes unrealised gains, which do not necessarily correspond with every person's understanding of income.

58. Appendix B to the Group's Interim Report stated the key reasons for applying tax on realisation:

> At its core, realisation involves the sale of an asset for market value. The purpose of imposing tax on realisation rather than accrual is that it ensures the tax is imposed at a time when the person subject to the tax **has the funds to pay** it, and when the **amount of the gain has been finally determined**. However, it is well established that there is a realisation even when the consideration for a sale is in kind rather than cash, and when payment of the consideration is deferred, for a shorter or longer period. This can perhaps be explained on the basis that the seller **has a choice as to whether to sell**, and if it is concerned about its ability to pay the tax, can either require some immediate cash component or not sell at all.

59. Within this statement there are three reasons for taxing the capital gain at the time an asset is actually sold:

- There is an ability to pay the tax from the sale proceeds.
- There is accurate measurement of the gain based on the sale price.
- The decision to sell is within the taxpayer's control.

60. The same reasons should be considered when evaluating which situations should qualify for rollover treatment.

61. The reasons for not favouring a tax on gains as they accrue are the reverse of the reasons why it is considered acceptable to tax gains that have been actually realised from selling the asset. These reasons are summarised in the table below:

Reasons for not taxing on accrual	Reasons for taxing as gains are realised
Cash flow pressures for assets that do not produce regular streams of cash income creates ability to pay issues and may force sales	There is an ability to pay the tax from the sale proceeds
Valuation challenges for assets that are not easily valued (e.g. intangibles).	There is accurate measurement of the gain based on the sale price
Perceptions of unfairness as the decision which triggers the tax is not within the taxpayer's control	The decision to sell is within the taxpayer's control

62. Another way of presenting these differences is shown in the table below:

Rationale for taxing gain	Taxing a gain that has accrued	Taxing a gain that has been realised on sale
Ability to pay tax without a forced sale (cash flow / divisibility of asset)?	No	Yes
Accurate measurement of gain?	No	Yes
Taxing event is within taxpayer's control?	No	Yes

63. These cases effectively represent the two ends of a spectrum. The cases where rollover treatment is contemplated are somewhere in the middle of this spectrum — i.e. some, but not all, of the reasons for taxing the gain are present. It may therefore be helpful to consider if the situation more closely resembles a case where the asset-owner has decided to sell the asset to a third party or a case where the asset-owner has decided to hold onto an asset in considering whether a particular situation justifies rollover treatment. It will also be important to consider the implications of any choice on how this helps or hinders the government in delivering on key objectives behind the ETCI reform.

64. The table in the **Appendix** shows which reasons for preferring taxation on realisation (ability to pay, accurate valuation, within taxpayer's control) are made out for each situation in which rollover is being contemplated.

65. We note for the avoidance of doubt that in some areas, the current income tax does tax on an accrual basis. For a zero-coupon bond (a bond that pays no interest but increases in capital value over time), gains are taxed on accrual because if they were

not, the tax treatment of a zero-coupon bond would incentivise the use of that financial instrument over other, closely-substitutable assets (e.g. a compound interest loan). While there is no cash to pay the tax that is due, the gain could have reasonably been foreseen when entering into the financial arrangement.

3.3 Other "public policy" reasons for rollover treatment

66. There is a risk that allowing rollover for "public policy" reasons would open the door to lobbying for more and more rollover situations. This could lead to "ad hoc rollovers" that do not reflect sensible tax policy, which was one of the Group's concerns in the Interim Report. The Secretariat therefore recommends that a high hurdle needs to be met before rollover is allowed.

67. The Secretariat considers there are two situations where rollover may be justified on public policy grounds:

- Relationship property divisions (discussed in Chapter 8); and

- Māori collectively-owned assets (discussed in Chapter 9).

4. No change in ownership in substance

68. This Chapter discusses why rollover treatment may be justified for business transactions that result in a realisation of assets but no change in ownership in substance of the underlying assets.

4.1 Business transactions with no change in ownership in substance

69. Such transactions may include:

- Incorporation by a sole trader. For example, a sole trader decides to incorporate a company and put their business assets into the company.
- Transfers within a wholly-owned group.
- De-mergers. These are equivalent to intra-group transfers within a wholly-owned group.

70. The key reason for rollover in these situations is economic efficiency. The "lock-in" effect may otherwise prevent an economically efficient restructuring (e.g. where a sole trader decides to incorporate a company). Lock-in may be more significant in the case of restructuring, since many restructurings involve legal realisations of many or all of a taxpayer's assets. If rollover is not allowed in these sorts of situations, there may be significant taxes on firms that have not initially structured themselves in the most sensible ways. This creates unnecessary and undesirable traps for the unwary.

71. Integrity risks will, however, need to be considered in designing any rollover treatment to ensure that it does not create any avoidance opportunities. In particular, business restructurings that qualify for rollover treatment should not include what are, in substance, dividend substitution arrangements. Alternatively changes could be made to the dividend rules to catch the arrangements that are not caught by the tax avoidance provisions.

4.2 Secretariat recommendation

72. The Secretariat recommends that rollover treatment should apply to business reorganisations where the ownership of the assets being realised has not changed in substance, provided integrity concerns are addressed. As shown below, only one of the reasons for taxing on realisation rather than on accrual applies.

REASON FOR TAXING ON REALISATION	No change in ownership in substance and no consideration – business transactions
Ability to pay tax	No – suggests a case for rollover
Accurate valuation	No – suggests a case for rollover
Taxing event within taxpayer's control	Yes
Secretariat recommendation	**Rollover**

5. Certain involuntary events

73. This Chapter considers whether there should be rollover treatment in certain circumstances where a taxpayer involuntarily realises an asset and reinvests the proceeds in a similar replacement asset.

5.1 Qualifying involuntary events

74. Examples of involuntary events that could qualify for rollover treatment include:

- Land taken under the Public Works Act 1981.

- Assets destroyed by a natural disaster or similar event. In this case there will be a gain if any insurance proceeds or other compensation exceed the asset's cost base.

75. It should be noted, that there are many other circumstances where taxpayers might claim an asset sale was involuntary in some sense. Selling assets may be involuntary for those who face a cash flow crisis. Market events may also trigger an involuntary realisation of an asset.

76. For example, shares may be compulsorily acquired by a controlling shareholder who has reached a threshold shareholding. This sort of event is a normal commercial risk that can be expected when a person acquires shares, and the argument that rollover treatment is necessary to prevent horizontal inequities with other shareholders is not as strong. Generally, compulsory acquisition occurs in a context where everyone in the company either sold, or has to sell at the same time. Accordingly, there is no comparison to a taxpayer who has not sold their shares.

77. Moreover, the Secretariat proposes that one of the conditions for rollover (discussed below) is to require the taxpayer to invest their sale or insurance proceeds in the same type of asset. It would be practically impossible to enforce that in the context of a share. A share in an agricultural company could hardly be said to be similar to a share in a technology company. Even where shares are in companies in the same industry, the taxpayer would acquire a very different "parcel" of ownership rights and liabilities in each case.

78. The Secretariat therefore does not recommend that rollover be extended to a sale during a cash flow crisis or a compulsory share sale in a takeover. This is consistent with the general desire to set a high hurdle before considering rollover treatment.

5.2 Reasons for rollover treatment

79. Rollover treatment for involuntary events may be justified for the following reasons:

- **Fairness**. As noted above, where events are generally outside the taxpayer's control, it may be seen as unfair from a horizontal equity perspective to tax the taxpayer as other asset owners only pay tax if they choose to sell. Many of these involuntary events also involve some form of misfortune or loss for the taxpayer so it could be perceived as "unfair" for the Government to be profiting from the person's misfortune.

- **Integrity**. As events are involuntary, taxpayers generally are not able to "cherry-pick" by deferring tax on gains while realising tax losses. Rollover in these situations is unlikely to create a significant integrity risk, which mitigates the need for loss ring-fencing.

80. Arguments against rollover in these circumstances include:

    - **Complexity**. Any rollover treatment necessarily requires a degree of complexity.

    - **Efficiency**. As events are involuntary, the rollover does not solve any short-term lock-in problems but contributes to longer-term lock-in.

81. The Secretariat recommends that rollover treatment be provided for these involuntary events on the basis of the horizontal equity concerns (a taxpayer with similar assets to another taxpayer being treated more harshly after suffering a natural disaster or compulsory acquisition).

5.3 Reinvestment in similar replacement asset

82. The rationale for allowing rollover treatment for involuntary events is much stronger in cases where the taxpayer reinvests the proceeds from the asset in a similar replacement asset. Allowing rollover treatment in these cases allows the affected taxpayer to choose to remain in the same tax position as if the involuntary event had not occurred.

83. However, if the taxpayer chooses to purchase a different type of asset, they would have effectively made a decision to "exchange" their original asset for a different asset. This is similar to a realisation by sale, so arguably the taxpayer should be treated the same as taxpayers who actually sold an asset. All of this is consistent with setting a high hurdle for allowing rollover treatment.

84. There are two main disadvantages to limiting rollover treatment to the same asset type:

    - **"Lock-in" biases (efficiency)**. The limitation would create a "lock-in" bias by creating a tax incentive to invest in the same asset, even if another investment makes more commercial sense.

    - **Complexity and compliance costs**. Rules and guidance on what assets qualify as a "similar" asset would be required, which adds complexity and compliance costs.

85. It should also be noted that taxpayers affected by the Canterbury and Kaikoura earthquakes were allowed rollover treatment for depreciation recovery income, if

they received insurance proceeds exceeding the tax book value of destroyed depreciable assets and acquired a similar replacement item.

86. Overall, the Secretariat recommends requiring the reinvestment to be in the same type of asset as this achieves the objective of putting the asset owner in a similar position to if the involuntary event had not occurred. This is consistent with the rollover treatment for depreciation recovery following the Canterbury and Kaikoura earthquakes.

5.4 Secretariat recommendation

87. The Secretariat recommends rollover treatment where a taxpayer involuntarily realises an asset and reinvests the proceeds in a replacement asset as a result of:

- land taken under the Public Works Act 1981; or
- assets destroyed by a natural disaster or similar event.

88. The table below illustrates that while there is an ability to pay the tax and an accurate measurement of the gain, the event that gave rise to the tax was completely outside the taxpayer's control.

REASON FOR TAXING ON REALISATION	Involuntary disposal, similar replacement asset	Involuntary disposal, any replacement asset
Ability to pay tax	Yes	Yes
Accurate valuation	Yes	Yes
Taxing event within taxpayer's control	No – suggests a case for rollover	Mixed – initial event not in taxpayer's control but control over divestment
Secretariat recommendation	**Rollover**	**No rollover**

6. Voluntary sales and reinvestment

89. The previous Chapter discussed involuntary events. This Chapter considers whether rollover treatment should be allowed in cases where the decision to sell the original asset was within the taxpayer's control and the proceeds of sale are reinvested in a replacement asset.

6.1 Reasons for rollover treatment

90. The main argument for rollover treatment when proceeds from an asset sale are invested into other assets is that it reduces, in the short-term, the "lock-in" biases described in Chapter 2. The lock-in problem only arises when assets have appreciated in value, such as land. Many business assets depreciate. Currently, there can be a lock-in incentive for assets which have depreciated at a slower rate than tax depreciation, because the depreciation deductions are "clawed back". We do not provide rollover treatment in these cases when assets are sold voluntarily, and in the Secretariat's view maintaining this position for appreciating assets is the better position given the problems outlined below.

91. A secondary argument for rollover treatment in this situation is that the gain arguably has not "come home" to the taxpayer because the taxpayer has reinvested the sale proceeds and has not enjoyed the benefit of (or "consumed") their gain. A counterargument is that the rest of the income tax does not rely on the income being consumed, and if capital income taxation is to be extended, the general principles of income taxation should be adhered to where possible.

6.2 Reasons against rollover treatment

92. Many of the negative impacts of rollover treatment generally (outlined in Parts 2.3 and 2.4 of Chapter 2) also apply to rollover treatment for replacement assets:

- **Efficiency (different "lock-in" biases)**. While rollover treatment limits short-term lock-in, it exacerbates long-term lock-in. Also, where rollover treatment is limited to "similar assets", there can be incentives to switch to assets that are less productive than other assets, but come within the restrictions of the rollover treatment (i.e. they are "similar" to the assets disposed of). This can reduce efficiency as discussed in Chapter 2. If rollover treatment is not restricted to "similar assets" then the tax itself would be heavily undermined and might only rarely apply.

- **Fairness**. Horizontal equity will be reduced as taxpayers with the same level of income can have very different tax liabilities, depending on how they choose to invest their asset sale proceeds. The horizontal equity concerns that push in the other direction for involuntary disposals are not relevant where the taxpayer has a choice to defer taxation by not selling. This is also likely to reduce progressivity and vertical equity because wealthier people are more likely to be in a position to reinvest into replacement assets (as opposed to needing the funds to meet other expenses).

- **Complexity and compliance costs**. Identifying situations where rollover treatment is required would increase complexity and compliance costs.

- **Reduced revenue**. The amount of tax revenue raised is likely to be significantly reduced as the tax liability may be deferred until the gain is consumed. US data for individuals from 2011 suggests that providing rollover treatment for "like-kind" exchanges of assets meant that between 5% to 32% (depending the type of asset) of the relevant gains were rolled over as opposed to being taxed in that year (see the earlier table in paragraph 37 of Chapter 2 for more detail).

- **Integrity risks**. Unless additional loss ring-fencing rules are introduced, taxpayers may be able to "cherry-pick" and defer tax on gains while realising tax losses that are used to shelter tax on other income. If there were additional loss ring-fencing rules, this would have negative impacts on the fairness, efficiency and simplicity of the rules.

93. Overall, the Secretariat considers that the arguments for not providing rollover treatment are more convincing. We recommend no rollover treatment for voluntary asset sales which are reinvested in replacement assets as providing rollover in these cases could significantly undermine many of the objectives of the ETCI.

6.3 Qualifying assets

94. If rollover treatment were provided it would be necessary to consider what types of assets could qualify. These options include:

- **Business premises only**. Requiring the original and replacement assets to both be business premises;

- **Similar replacement asset**. Allowing rollover on like-for-like assets where the replacement asset is "similar" to the original asset and both assets are used to conduct the same business activity; or

- **Any business capital asset**. Allowing the relevant business owner to replace any asset with any other business asset including switching into a different type of business activity.

Business premises and similar replacement assets

95. As explained above in Chapter 2, while rollover treatment for business premises or similar replacement assets may promote efficiency by reducing a taxpayer's disincentive to upgrade to a more productive asset, it can also create "lock-in" into an asset class. The "lock-in" into a particular asset class will reduce efficiency if investment in another asset class would have been more productive.

96. The efficiency effects of rollover treatment for business premises or similar replacement assets are therefore uncertain. If rollover is provided, the question arises of why it should not also extend to any other capital business asset. But going

in this direction would mean that ETCI could lead to very long or indefinite deferrals of tax which would compromise the success of the tax in addressing fairness concerns.

Any capital business asset

97. If rollover treatment is allowed for any capital business asset, the fairness and efficiency benefits from extending the taxation of capital income would largely be removed. However, the complexities, and inefficiency disadvantages of the tax would remain.

98. This option would create an incentive to reinvest proceeds from a capital asset in another capital asset, whereas in some cases it may make more commercial sense to apply the proceeds to business expenses (e.g. wages, research and development, trading stock) or to repay debt, rather than to another capital asset.

6.4 Cost base allocation of replacement asset

99. One complexity is how to allocate the cost base of the prior asset when several new assets are purchased. A possible formula is:

$$\textbf{Capital gain attributable to replacement asset} =$$

$$\textbf{disregarded capital gain} \times$$

$$\frac{\textbf{receipts expended on replacement asset}}{\textbf{receipts expended on all replacement assets}}$$

Example 11 – Rollover for any capital business assets
Capital Co. has developed a valuable patent with a cost basis of $1m. It sells the patent for $6m. The capital gain on the patent is $5m.
Assume there is rollover treatment for any capital business assets bought with the proceeds.
Capital Co. purchases new premises for $1m, and spends $2m on a minority stake in a small competitor it may want to eventually acquire. It purchases a bond that pays interest for $3m.
As the bond pays interest and is not expected to make a capital gain, it does not qualify for rollover treatment. $3m of gain is crystallised and taxed. $2m is rolled over into the new assets. In other words, it is not taxed, and the premises and shares have a basis of $1m in aggregate.
If the capital gain from the patent were allocated to the new assets in accordance with the above formula, $0.667m will be brought to account if and when the new premises are sold, and $1.33m will be brought to account if and when the shares are sold.

6.5 Other conditions for rollover

100. If rollover is provided for voluntary sales, the Secretariat recommends:

- taxpayers should be required to acquire "replacement" assets within specified time periods (e.g. 1 to 2 years); and

- rollover should not be provided to taxpayers who trade or deal in the taxable assets. A distinction will need to be drawn between “traders” and other owners of assets. Such a distinction could be based on some or all of existing sections CB 1 to CB 5 of the Income Tax Act 2007 and relevant case law. This would reduce (or eliminate) any simplification benefits of an ETCI.

6.6 Secretariat recommendation

101. The Secretariat considers that extending rollover treatment to voluntary sales and reinvestment of business assets would substantially negate the benefits of ETCI. We recommend no rollover treatment for voluntary asset sales which are reinvested in replacement assets. As shown in the table below, most of the reasons for taxing on realisation rather than on accrual apply to these options.

REASON FOR TAXING ON REALISATION	Voluntary sale, business premises	Voluntary sale, similar replacement asset	Voluntary sale, any capital business asset
Ability to pay tax	Yes	Yes	Yes
Accurate valuation	Yes	Yes	Yes
Taxing event within taxpayer’s control	Yes	Yes	Yes
Secretariat recommendation	**No rollover**	**No rollover**	**No rollover**

7. Death and gifting events

102. A gift is a transfer for no consideration. Gifts may take place during a taxpayer's life or on their death (for simplicity, when this paper uses the term "gifts" it is referring to gifts made while a person is alive). This Chapter sets out separately the Secretariat recommendations for:

- Transfers of qualifying illiquid assets on death;
- Transfers of other assets on death;
- Gifts of qualifying illiquid assets; and
- Gifts of other assets.

7.1 Consistent tax treatment for gifts and transfers on death?

103. In the Interim Report the Group suggested that the tax treatment for transfers on death should be consistent with the treatment of gifts during a taxpayer's lifetime. Any distinction between the two could lead to unnecessarily complex tax planning and economic inefficiencies.

104. However, a key difference between gifts and transfers on death is that death is not typically an event the taxpayer can control, whereas gifting is. If rollover treatment was allowed for gifts to close relatives, the rollover rules would effectively need to override any other associated persons rule which would otherwise treat the transfer as occurring at market value for tax purposes.

105. There are good reasons for such associated persons rules. Non-market value transfers can be used to exploit asymmetrical tax positions of the transferor and transferee. For example, if rollover treatment applied to gifts of shares, a taxpayer may be able to gift appreciated shares to an associate on a lower tax rate (e.g. a spouse, child or company) before the share is sold, so that the gain is realised by the person on the lower tax rate.

Gifts to non-natural persons

106. Avoidance opportunities could be increased if rollover treatment applied to gifts to non-natural persons. For example, taxpayers could gift appreciated assets to an associated company before realising the asset to take advantage of a lower tax rate, or to a company with accumulated tax losses that could not otherwise be used.

Example 12 – Gift to associated company on lower tax rate

Stan owns 90% of the shares in Dormant Co, and his wife owns the remaining 10%. Stan's marginal tax rate is 33%.

Stan wishes to realise his share portfolio, which has a current market value of $1m (cost base $200,000). If Stan sells his portfolio, he will derive a taxable gain of $800,000 and pay tax of $264,000.

If rollover were allowed for gifts to any person, Stan could gift his portfolio to Dormant Co and Dormant Co could sell the portfolio. Dormant Co's gain is taxed at the lower corporate rate of 28%, so it only pays tax of $224,000. The difference of $40,000 (from the 5% differential in the company and top marginal tax rate) will not be taxed until the sales proceeds are distributed to Stan.

Example 13 – Gift to company with accumulated losses

Jasmine owns 100% of the shares in her failed start-up Loss Co. Loss Co has accumulated tax losses of $100,000 and no prospect of recouping its losses.

Jasmine's friend, Mary, owns a rental property with a market value of $300,000 (cost base $200,000). Her tax rate is 33%. If Mary sells her property, she will derive a taxable gain of $100,000 and pay tax of $33,000. Her after tax sales proceeds will be $267,000.

If rollover were allowed for gifts to any person, Mary could gift her property to Loss Co and Loss Co could sell the property. Loss Co derives a gain of $100,000 but offsets this against its accumulated losses so it does not pay any tax. Loss Co keeps $20,000 and returns the balance of the sale proceeds ($280,000) to Mary.

Although the transfer of sale proceeds back from Loss Co should mean the initial transfer from Mary to Loss Co is not a gift, the transfer of sale proceeds may not be disclosed, or the transaction could be structured so that there is no clear link between the two transactions.

107. Although anti-avoidance rules could counter some forms of abuse, rollover treatment would put pressure on these rules to protect the tax base. It may also be difficult to design anti-avoidance rules for circumstances which may be complex and unforeseen.

Secretariat recommendation

108. Avoidance opportunities could be mitigated if rollover treatment were limited to transfers on death. This would create an incentive to hold strongly appreciated assets until death, rather than transferring them at a more convenient time in their life, which is a trade-off the Group will have to consider.

109. If rollover for gifts is allowed, the Secretariat recommends that it be confined to gifts between a natural person and another natural person and gifts between natural persons and some specified non-natural persons that are less likely to pose an avoidance risk (e.g. Māori entities and possibly some family trusts).

7.2 Transfers of assets on death — qualifying illiquid assets

110. Rollover treatment may be justified for bequests of certain illiquid assets on complexity and compliance cost and efficiency grounds:

- **Complexity and compliance costs**. As some illiquid assets are not easily valued, it could be costly and difficult to identify the market value at which the transfer is deemed to take place.

- **Efficiency**. If tax applied to transfers of illiquid assets on death, the deceased's estate may not have the funds to pay the tax. Cash flow difficulties could result in very inefficient outcomes. For example, an operating family business may need to be wound up because tax needed to be paid after an owner has died.

111. The complexity and efficiency disadvantages in taxing illiquid assets are mostly caused by difficulties with accurate valuations and ability to pay. These are two of the reasons why taxing on realisation was preferred over taxing on accrual.

112. To mitigate these concerns, the Secretariat suggests that rollover treatment should apply to transfers of certain illiquid assets on death.

Qualifying illiquid assets

113. The complexity and efficiency disadvantages outlined above do not apply to all assets. When assets are liquid and readily divisible (e.g. shares), the estate may sell off some of the assets to fund the tax. If assets are not divisible (e.g. land), the estate may be able to borrow against the assets on a secured basis to pay the tax, and assets could be passed on to beneficiaries subject to the debt.

114. To ensure rollover treatment is not extended to unintended cases, there should be a defined list of qualifying illiquid assets. This list should include assets where imposing tax could cause ability to pay or valuation issues, and may include:

- shares, land and other assets in active unlisted companies and unincorporated businesses;[1] and
- land whose legal nature means it is very difficult to sell or use as security for a loan (e.g. interests in Māori freehold land).

115. The list of qualifying illiquid assets should **<u>not</u>** include assets that can be readily valued and may be divisible or borrowed against to fund the tax, such as:

- shares in listed companies;
- rental properties;
- holiday homes; or
- any other land or commercial property which was rented or held outside the context of a business whose assets qualify for rollover treatment.

116. Some rules would be required to ensure that taxpayers could not convert liquid assets into "qualifying illiquid assets" by, for example, holding a share or rental portfolio in a private company.

117. The reason non-business land should not be treated as a qualifying illiquid asset is because land valuations are common and relatively reliable. The market for most

[1] This paper does not deal with the question of whether there should be a *de minimis* for small business tax gains. That will be considered elsewhere.

land is more liquid than for most businesses, and it is more easily able to be borrowed against. This is all part of making ETCI as broad as possible.

118.Farms and farmland could fall on either side of this list. In many cases, the land will be easier to value and sell than other businesses (the value of farms is more likely to be attributable to the land than any goodwill generated by the particular owner at any given time). From another perspective, farms are small businesses and it may be seen as unfair to single them out as being more 'liquid' than other businesses and so taxed on death. Overall, the Secretariat considers there is a better argument to treat farmland as an illiquid asset (so long as it is owned by an active business that is unlisted or unincorporated).

119.The proposed distinction between qualifying illiquid assets and other assets may create other distortions, including a disincentive to list a private company publically. However, in the context such a decision, other factors are likely to be of much greater importance than the tax treatment of gains when shareholders die.

120.It should be noted that some countries including Canada and South Africa provide very limited rollover on death,[2] and allowing rollover for 'qualifying illiquid assets' could reduce vertical equity. Gains accruing to some of the wealthiest New Zealanders may be as gains in the value of unlisted companies, which may not end up being taxed on death. There may also be other ways of addressing valuation and cash flow concerns, such as using accounting values or allowing any tax payments to be deferred.

Secretariat recommendation

121.The Secretariat considers that on balance, rollover treatment should apply to transfers of qualifying illiquid assets on death.

122.The Secretariat considers that whether to allow rollover treatment for certain illiquid assets is a borderline decision. While the Secretariat is conscious of the impact such a rule may have on vertical equity, we recognise that valuation problems and ability to pay are significant concerns. To mitigate these concerns, the Secretariat suggests on balance that rollover treatment should apply to transfers of qualifying illiquid assets on death.

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[2] In Canada there is only rollover on death for:

- Transfers to spouses or common-law partners; and
- Transfers of farm, forests or fishing assets made to the deceased's child (or step-child or grandchild).

South Africa provides rollover for a very small lifetime *de minimis* of R1.8m ($192k NZD) of capital gains from active assets of small businesses that have less than R10m ($1.07m NZD) of total assets. This *de minimis* applies upon death or retirement (aged over 55 or sick) of the small business owner / operator.

South Africa also provides rollover for any assets transferred to a surviving spouse.

123. The Secretariat does not consider that rollover treatment in these situations should depend on the relationship of the recipient to the transferor, as the complexity and efficiency concerns above apply regardless of the relationship.

7.3 Transfers of other assets on death

124. As the list of qualifying illiquid assets should include assets where imposing tax could cause ability to pay or valuation issues, the reasons for rollover treatment on death do not apply to transfers of other assets where these issues do not arise. There may, however, be other reasons for rollover of other assets depending on the recipient's relationship with the deceased.

125. Possible recipients may include:

- The spouse, civil union or de facto partner of the deceased;
- Other natural persons for whom the deceased has natural love and affection (e.g. children, grandchildren, parents); or
- Any other person (e.g. a related company, a friend, unrelated charity or organisation).

126. The fairness, efficiency and revenue impact considerations point against rollover treatment for transfers of other assets on death generally:

- **Fairness and vertical equity** (progressivity). Rollover treatment for transfers of other assets on death is likely to make the tax system less progressive. Wealthier taxpayers are much more likely to bequeath and inherit assets so any ability to defer tax on these events will be of most benefit to them. Furthermore, people who are less wealthy are more likely to sell assets soon after receipt to pay for expenses (see Example 14 below). In contrast, wealthy people tend to have more diversified portfolios so wealthy families may be able to pass down assets for many generations without the assets being taxed.
- **Efficiency**. Allowing rollover treatment for transfers on death is economically inefficient, as it increases "lock-in" biases. Taxing gains accrued up to the date of death ensures that capital gains cannot be deferred for longer than a taxpayer's lifetime. By re-setting the cost base of the assets, taxing on death reduces lock-in biases for future transactions (by making it less unattractive for the new owner to sell the asset) and reduces the economic inefficiency of a realisation-based tax. Because death cannot be avoided, there is no "lock-in" issue for a death-based realisation.
- **Revenue impact**. Rollover treatment for gifts and transfers on death is likely to reduce the amount of revenue raised by the tax significantly.

Example 14 – Rollover treatment on death and impact on vertical equity

Craig inherits several rental properties, a holiday home and shares from his father. These assets are worth $5m of which $2m unrealised gains. As Craig has a well-paying job and is financially secure he does not need to sell any of these inherited assets.

Providing rollover treatment on death means that up to $660,000 of tax ($2m taxed at 33%) is deferred until the assets are sold. The deferred tax also creates "lock-in" by discouraging Craig from selling any of the inherited assets, such as the holiday home, in order to invest in other assets such as shares which have higher pre-tax returns.

Craig continues to hold the assets until he dies in 20 years' time. His daughter Rosie inherits the assets which she holds for another 10 years before she sells all of the assets. At that time tax is finally paid on the unrealised gains. Tax has been deferred for 30 years due to the rollover treatment.

In contrast, Mary inherits a share portfolio worth $80,000 from her mother of which $50,000 is unrealised capital gains. Mary needs to sell all of these shares immediately to meet expenses and pay off debts. If Mary has no other income she will pay tax of $8,020 on the $50,000 of capital income she realises from selling the shares.

Because the rollover treatment provided 30 years of deferral in the first case involving Craig and none in the second case involving Mary, providing rollover on death is likely to provide bigger benefits to those who are able to continue to own the assets for a considerable period of time.

These examples illustrate how the benefit (and corresponding fiscal cost) of providing rollover treatment on death will be predominantly enjoyed by wealthier individuals who inherit more assets and are less likely to need to sell those assets. Less wealthy individuals may not receive much or any benefit from the rollover.

127. The negative impacts of allowing rollover treatment for transfers on death are lessened if it is confined to transfers on death to spouses, civil union and de facto partners. There is less potential for such rollover to defer the taxing point for a very long period, compared to rollover for transfers to a taxpayer's children. As such, it is less likely to increase "lock-in" biases and would be less inefficient. If rollover is limited to transfers to spouses and partners, it is also less likely to significantly reduce vertical equity or tax revenue.

128. Another reason for allowing rollover for transfers to surviving spouses or partners is because rollover should also apply to relationship property settlements (see Chapter 8). A relationship property settlement under the Property (Relationships) Act 1976 can occur on the break-up of a relationship, and also on the death of a spouse or partner. For consistency of treatment and simplicity, it is proposed that rollover should apply to all transfers on death to surviving spouses or partners.

Secretariat recommendation

129. The Secretariat recommends rollover treatment should apply to transfers of any asset on death to a taxpayer's spouse, civil union or de facto partner.

130. The Secretariat does not recommend rollover treatment for transfers on death to other persons (other than for qualifying illiquid assets, as noted above).

7.4 Gifts of qualifying illiquid assets

131. If rollover is allowed for transfers of qualifying illiquid assets on death, rollover on gifts of those assets could also be considered. Rollover on gifts of qualifying illiquid assets would enable a taxpayer to pass on these to the intended recipients during their lifetime. This would reduce "lock-in" of waiting until death, by allowing the relevant assets to be transferred at more economically efficient or personally desirable points in time.

132. However, allowing rollover on gifts of qualifying illiquid assets could create avoidance opportunities. For example, a taxpayer wanting to sell 5% of the shares in their closely-held start-up to a third party could gift those shares to their spouse on a lower marginal tax rate and have the spouse sell them. These risks are explained further at Part 7.1 above. This is a trade-off that the Group will have to consider.

133. On balance, the Secretariat recommends there should be no rollover for gifts of qualifying illiquid assets.

7.5 Gifts of other assets

134. The Secretariat does not recommend rollover for transfers on death of other assets, so there does not appear to be any reason to allow rollover for gifts of those assets. In addition, rollover treatment on gifts creates avoidance opportunities (see Part 7.1 above). The Secretariat recommends there should be no rollover for gifts of other assets.

7.6 Trusts

135. As settlements on trusts are a type of gift, rollover can also apply to settlements on trusts. However, the rollover rules would need to ensure that trusts cannot be used to avoid what would otherwise be a realisation without rollover.

136. The Secretariat recommends that where the terms of the trust are such that the treatment would necessarily apply if the gifted property had instead moved directly from the settlor to the trust beneficiaries, rollover should apply to both the settlement into and distribution out of the trust. This general principle should be subject to anti-avoidance rules to ensure trusts are not used to avoid realisations.

7.7 No rollover for transfers to non-residents

137. When the recipient of the asset is a non-resident, the effect of the transfer is generally that, unless the asset is New Zealand land or business assets of a New Zealand permanent establishment, New Zealand loses the right to tax any gain on the asset. Accordingly, rollover treatment should not be provided on transfers of assets to non-residents if New Zealand would otherwise be unable to apply the tax the gains that accrued while the asset was held by a New Zealand resident.

138. This would be consistent with treating migration as a realisation event and applying the tax when an asset-owner becomes non-resident. This issue will be further considered in the upcoming session on international tax and migration scheduled for 8-9 November.

7.8 Consistent treatment of revenue account property and taxable capital assets

139. The Secretariat considers the tax treatment of transfers on death and gifts should apply equally to revenue account property and taxable capital assets for reasons of fairness, efficiency and simplicity.

7.9 Secretariat recommendations

140. The Secretariat's recommendations are summarised in the table below. The table shows there is a stronger case for applying rollover treatment on transfer on death and gifts of qualifying illiquid assets.

141. The Secretariat considers that fairness, integrity and revenue impact considerations point against rollover treatment for gifts made while a taxpayer is alive. Integrity concerns are particularly pronounced for gifts to non-natural persons (e.g. companies) and are less strong for transfers on death.

RATIONALE FOR TAXING ON REALISATION	Death, qualifying illiquid asset	Gift, qualifying illiquid asset	Death, other asset, to spouse/ partner	Death, other asset, to other person	Gift, other asset
Ability to pay tax	No – suggests a case for rollover	No – suggests a case for rollover	Yes	Yes	Yes
Accurate valuation	No – suggests a case for rollover	No – suggests a case for rollover	Yes	Yes	Yes
Taxing event within taxpayer's control	No – suggests a case for rollover	Yes	No – suggests a case for rollover	No – suggests a case for rollover	Yes
Secretariat recommendation	**Rollover**	**No rollover**	**Rollover**	**No rollover**	**No rollover**

8. Relationship property divisions

8.1 Reasons for rollover

142. Rollover treatment may be justified for relationship property divisions and settlements under the Property (Relationships) Act 1976 ("PRA"), on the grounds that it is undesirable for a tax to disincentivise people leaving unhappy relationships.

143. In addition, a division of relationship property can sometimes be similar to cases where legal ownership of assets has changed, but not the ownership in substance. Such a division does not increase the taxpayer's ability to pay the tax, nor does it provide an accurate valuation of the asset. In that sense, taxing divisions of relationship property faces many of the same drawbacks as taxing on accrual.

144. Moreover, from a horizontal equity perspective, the taxpayer may not have chosen to leave their relationship and, even if they did, they cannot be said to have "realised" their assets in the way that asset owners normally choose to realise their assets (i.e. by sale). Providing rollover in these situations is also unlikely to have a significant impact on revenue or integrity.

145. The Secretariat recommends that rollover treatment apply to transfers made in a relationship property settlement. This is consistent with subpart FB of the Income Tax Act 2007 which currently applies to "property transferred on a settlement of relationship property" (which includes court orders).

Example 15 – Relationship property settlement

Cersei and Robert are married and own the following assets as "relationship property":

- $250,000 rental property in Robert's name (cost base of $200,000);
- $300,000 excluded home, held jointly.

Cersei also has a cash inheritance of $100,000 which she holds as separate property.

Cersei and Robert break up, and Cersei receives sole ownership of the excluded home while Robert retains the rental property in his name. To make up the $50,000 difference between the two properties, Cersei also gives Robert $25,000 in cash.

Rollover should apply to all the transfers, so there is no taxable gain or loss to Cersei or Robert.

8.2 Limits on rollover to spouses and partners

146. The tax system normally operates on an individual basis and treats the spouses or partners in a couple as two separate taxpayers. Income splitting between spouses and partners is not permitted.

147. If rollover applied to transfers between spouses or partners more generally (i.e. outside the context of a relationship property settlement), couples could effectively split income from capital sales by ensuring that sales are realised by the spouse or partner with the lower tax rate.

Example 16 – No rollover outside of a relationship property settlement
Tyrion and Shae are in a de facto relationship. Tyrion wishes to sell some of his shares in Listed Co, market value of $50,000 and cost base of $30,000.
Shae is in a lower tax bracket than Tyrion, so Tyrion decides to gift his shares to Shae so that the gain on sale is taxed at a lower rate.
If there is no rollover, Tyrion will be deemed to have sold his shares to Shae for $50,000 as Shae is associated person. Tyrion will be taxed on a gain of $20,000.
If rollover applies, Tyrion will not be taxed on the share transfer and Shae's cost base in the shares will be $30,000. If Shae sells the shares some of the gain will be taxed at a rate lower than Tyrion's.

148. Accordingly, when a transfer is made outside the context of a relationship property settlement, rollover should not apply unless the transfer falls within a separate exception, such as those discussed in Chapter 7.

8.3 Secretariat recommendation

149. The Secretariat recommends that rollover applies to transfers between spouses, civil union or de facto partners (or former partners) in connection with a relationship property settlement.

REASON FOR TAXING ON REALISATION	Relationship property settlements
Ability to pay tax	Mixed (depends on liquidity of asset)
Accurate valuation	Mixed (depends on liquidity of asset)
Taxing event within taxpayer's control	Mixed
Secretariat recommendation	**Rollover**

9. Māori collectively-owned assets

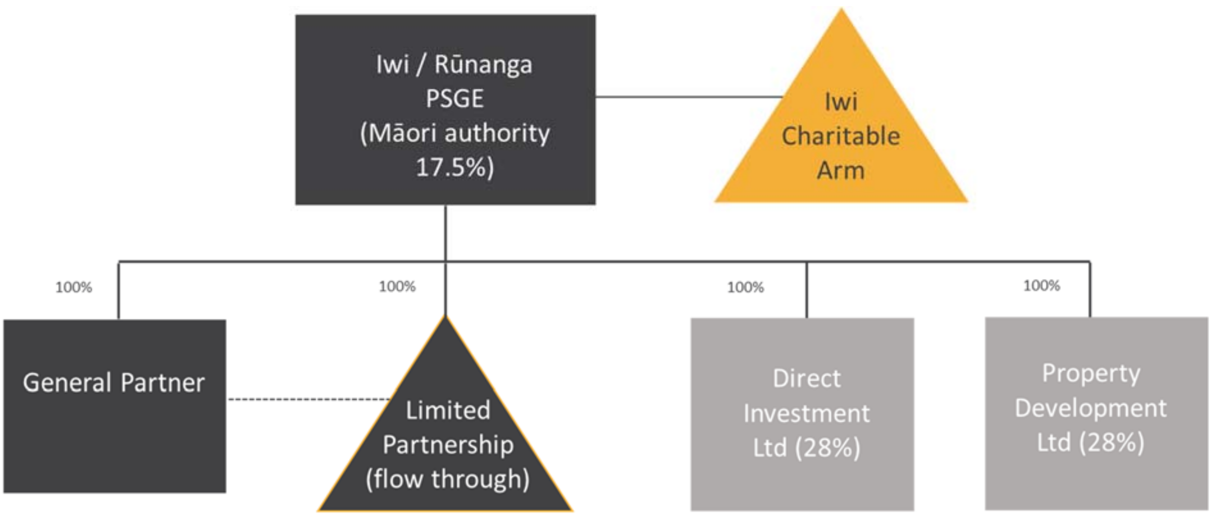
150. As previously set out in the Secretariat's paper *Extending the taxation of capital income: implications for Māori collectively-owned assets*, the Crown has a specific obligation under the principles of the Treaty of Waitangi to understand the impact of proposed policy changes for Māori, to consider how any negative or unintended effects might be mitigated, and to balance consideration of any impacts for Māori with broader public policy objectives.

151. This Chapter explores how Māori collectively-owned assets might be treated under the rollover treatment principles discussed in this position paper. This commentary is preliminary and is only intended to raise the relevant issues. Further analysis on this subject, including insights from Te Ao Māori perspectives, will be provided following the planned engagement hui as part of the future Secretariat paper on the Māori asset base. Officials are also consulting the Office of Treaty Settlements (Ministry of Justice) as part of this work.

9.1 Reorganisation and asset transfers

152. Chapter 4 recommended that rollover treatment should be provided to business reorganisations that would cause a realisation of an asset but which do not result in a change in the asset's ownership in substance. This would help to ensure that taxation is not an obstacle to the implementation of an efficient restructure of business assets.

153. We understand that some Māori organisations are structured using a combination of companies, charitable entities, and limited partnerships within one wholly-owned group. An organisation that is structured in this way (e.g. the Post-Settlement Governance Entity example below) will be able to access business reorganisation rollover treatment for a reorganisation of its assets to achieve its strategic objectives.



154. However, the Secretariat is also aware that this rollover treatment principle may not apply depending on the characteristics of the Māori organisation in question. For instance, there are groups that operate collaboratively according to whakapapa relationships (iwi and hapū) rather than relationships formalised through legal status. Asset transfers within such groups would result in a change of ownership in substance, and no rollover treatment would be available under the business reorganisation principle. Officials are engaging with Māori collectives to further understand Māori organisational structures and transactions.

155. The Secretariat is also aware of the asset reorganisation that can occur following Treaty settlement. Under a settlement, assets are transferred from the Crown to the PSGE, due to the Crown's policy of negotiating with large natural groups (which is sometimes contrary to Māori preference). Following this settlement, assets will often be transferred to different holding entities according to the needs of the various assets and the particular nature of the group. To the extent that such a transfer results in an actual change in an asset's ownership in substance (for example, a transfer from iwi to hapū), there may be taxation implications.

156. Where business reorganisation rollover treatment does not apply, there may still be merit in rollover treatment which recognises the nature of the Treaty settlement process and the reorganisation of settlement assets into related groups (hapū) following settlement. This could take the form of a specific post-settlement rollover approach that is time-limited.

9.2 Voluntary sales and reinvestment

157. Chapter 6 recommends that no specific rollover treatment should be provided for voluntary sales where the proceeds are reinvested in replacement assets.

158. The consideration of rollover treatment and the sale and reinvestment of Māori collectively-owned assets will depend on the Group's decisions in this area. If the Group wishes to provide wider rollover treatment than is recommended by the Secretariat, then this will naturally extend to at least some of the transactions that Māori groups will undertake.

159. For instance, an iwi that is gifted land by the Crown under a Treaty settlement may wish to sell that land in order to purchase a different parcel of land of special cultural value that was not part of the iwi's settlement package (e.g. because it was not in Crown ownership at the time of settlement). Wide rollover treatment for voluntary sale and reinvestment would likely mean that extending the taxation of capital income does not place an additional tax hurdle on an iwi group carrying out such a transaction.

160. In consultation, Officials intend to find out more about the types of transactions that Māori groups undertake which would not be included by such a broad rollover treatment principle.

161. A narrower rollover approach that does not provide any tax relief for voluntary sales and subsequent reinvestment would have an impact on Māori groups that are

intending to carry out transactions to restore their historic base. In the simple example of iwi land sale and reinvestment described above, extending the taxation of capital income would constrain the iwi's ability to regain control over ancestral land that was lost through Crown action. From one perspective, this is little different from the constraint that arises through taxing other income from capital (e.g. income tax on rental income, dividends, and interest) that Māori groups own. However, another perspective is that the lock-in incentives created by a realisation-based tax in effect create a tax system that disincentivises switching to otherwise-preferred assets, including ancestral land.

162. A potential justification for rollover is the arbitrary nature of asset receipt through Treaty settlement; the Crown can only provide redress to iwi using the assets that it owns. In order to recover assets of special importance not included in a settlement, Māori groups may enter into transactions which would not be undertaken had those assets been available to the Crown at the time of Treaty settlement. While these transactions are voluntary, they are carried out from a position that is uncontrolled and unintended.

163. Accordingly, in the design of extending the taxation of capital income, there may be a case for a special rollover approach for voluntary sales of Māori collectively-owned assets. It is important that any such approach is consistent with the overall policy intent of extending the taxation of capital income.

164. The nature of reinvestment assets that could be included in such an approach is an important issue that Officials wish to consider further following engagement hui. The following situations are of relevance to this issue:

- Reinvesting in an asset under a Treaty settlement right of first refusal;
- Reinvesting in assets that are mana whenua assets identified in the Treaty settlement process; and
- Reinvesting in other assets of cultural significance within the relevant rohe.

9.3 Māori freehold land

165. In considering extending the taxation of capital income, Māori freehold land is prima facie within the bounds of assets that would be subject to additional taxation upon sale. In reality, and as previously advised, Māori freehold land is rarely sold. The Secretariat paper *The excluded home* raised the issue of whether the excluded home and Māori freehold land are analogous. The Secretariat will report back to the Group on this issue following the engagement hui.

166. However, extending the taxation of capital income would apply to realisation events other than sale, such as gifting and death. In relation to these realisation events, this paper distinguishes between certain illiquid assets and other assets in considering the merit of rollover treatment. Māori freehold land should be a qualifying illiquid asset due to the legislative restrictions on sale and various practical issues including ownership registers which are often incomplete. Further,

the Secretariat considers that shares in Māori freehold land are similarly illiquid because they can generally only be transferred to a preferred class of alienees (based on whakapapa connection).

167. The Secretariat therefore considers that any rollover approach for gifting and death based on the illiquid character of assets should naturally extend to Māori freehold land. Such an approach would be consistent with kaitiakitanga as it would recognise the special nature of Māori freehold land; it is managed collectively for the long-term and not for any one generation of Māori.

10. Loss ring-fencing

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

- Loss ring-fencing would apply to:
    - portfolio listed shares and derivatives not already subject to the financial arrangement rules, with losses only able to be offset against capital gains and dividends from these assets;
    - losses from the sale of interests in attributing CFCs; and
    - losses arising from non-market transactions.
- Losses on land held for private purposes would be denied entirely.[3]

169.If the Group decides to recommend more expansive rollover treatment, we recommend additional loss ring-fencing rules.

10.1 Ring-fencing to address integrity risks of extensive rollover

170.Even if rollover treatment is made mandatory, a taxpayer may be able to choose not to apply rollover by ensuring they do not meet the requirements for rollover. For example, if rollover applies to business transactions with no change in ownership in substance and no consideration, a taxpayer could prevent rollover by including a token amount of consideration or creating a small change in ownership percentages.

171.Where a decision on whether to apply rollover is within a taxpayer's control, it creates an integrity risk that should be addressed by loss ring-fencing rules. There is greater integrity risk if the realisation event itself is also in the taxpayer's control (e.g. in gifts or voluntary sales). In these cases, rollover treatment can create a revenue integrity risk by allowing some taxpayers to defer tax while realising losses. Loss ring-fencing reduces this risk.

172.The relevant loss-ring fencing suggestions for each of the situations in which the Secretariat has recommended rollover are illustrated in the following table:

Type of rollover treatment	Suggested loss ring-fencing rule
Business transactions with no change in ownership in substance and no consideration	Required
Involuntary events, similar replacement asset	Required – a taxpayer may choose not to apply rollover by ensuring their replacement asset is not "similar" enough or that it is not purchased in the prescribed time period

[3] The Group has asked for information on how other countries treat losses on land held for private purposes and other private assets. We will report separately on that.

Death, qualifying illiquid asset	Not required
Death, other asset	Not required
Relationship property divisions and settlements	Not required

173.The Secretariat has not provided suggested loss ring-fencing rules for situations where it has not recommended rollover. However, our preliminary view is that if rollover is allowed in those situations, some integrity measures are likely to be required. These may take the form of loss ring-fencing rules, loss denial rules, or other specific anti-avoidance rules.

174.As explained in Chapter 2, providing more expansive rollover treatment, particularly in those cases where it becomes necessary to impose additional loss ring-fencing rules or other integrity measures, will have negative impacts on fairness, efficiency and simplicity objectives of the tax.

10.2 Other reasons for loss ring-fencing apart from rollover

175.There are more general integrity and fiscal reasons for loss ring-fencing, regardless of what decisions are made on rollover.

General integrity reasons for loss ring-fencing

176.The Group explained these general integrity reasons in the Interim Report in Appendix B (at paragraphs 101 to 105):

> Taxing capital gains on a realisation basis raises a particular problem in this respect. Because taxpayers can decide whether or not to sell an asset in a particular year, they can choose to sell depreciated assets in order to accelerate the tax benefit of the loss and retain appreciated assets in order to defer the tax cost.
>
> This kind of cherry-picking is particularly problematic:
>
> - in the case of fungible assets, where the sale of a depreciated asset to realise a tax loss can be followed immediately by the acquisition of an identical asset. Effectively, the taxpayer can return losses on an accrual basis and gains on a realisation basis;
>
> - in the case of traded assets where there is also a traded hedge. Taxpayers can generate a tax loss with very little economic cost or risk by acquiring offsetting assets (for example, a call and a put over the same shares) and selling the asset with a loss just before the end of the year, then selling the asset with a gain just after. This is often referred to as a straddle transaction. The ability to use straddle transactions to generate tax benefits may be diminished in New Zealand to the extent that the assets which would be used in such transactions are financial arrangements and so already subject to comprehensive taxation on some form of accrual basis.
>
> In many countries, these issues mean that capital losses are ring-fenced, so that they can only be used against capital gains.
>
> For assets that are not fungible, there is of course a real consequence of selling a lossmaking asset, as well as a tax consequence. The seller has given up its exposure to the

asset, and thus the chance to recoup its loss. Similarly, a person who retains an appreciated asset is taking the risk that the asset will decline in value.

At this stage, the Group proposes that ringfencing of losses apply to:

- Portfolio listed shares and derivatives that are not already treated as financial arrangements. Losses should be able to be offset only against capital gains and dividends from such assets.

- Land held for private purposes. Such losses should be non-deductible altogether, on the basis that they represent private consumption.

- Losses arising from non-market transactions.

Fiscal reasons for loss ring-fencing

177. There may be the question of whether capital loss ring-fencing is required more widely to protect government tax revenue in a downturn. There are two main considerations: the potential impact of greater cyclicality of revenues and whether the fiscal risk is manageable in the context of the overall revenue base.

178. The countercyclical nature of the tax (that revenues move in the opposite direction of the business cycle) is generally a benefit in terms of supporting economic stability (enhancing the automatic stabilizers). However, this does require disciplined fiscal management to ensure that the automatic stabilisers are able to fully operate (e.g. government spending does not rise unsustainably when there is an asset price boom that increases revenues temporarily).

179. The effect of ETCI on revenue volatility will depend on the nature of asset price developments, which are inherently uncertain. Further advice on fiscal risk will be provided in the Overview paper in session 21.

Appendix: Table of potential rollover situations

The table below shows the situations in which rollover treatment is being considered. It shows whether each reason for preferring taxation on realisation (ability to pay, accurate valuation, within taxpayer's control) is made out for each situation. When fewer reasons for taxing on realisation apply to a situation, the case for rollover for that situation is more compelling. However, the factors in the table are only guides as there are other reasons such as fairness, efficiency, and integrity that support rollover even when some of the reasons for taxing on realisation are made out (e.g. transfers to spouses on death), and vice versa (e.g. gifts of qualifying illiquid assets).

REASON FOR TAXING ON REALISATION	No change in ownership in substance and no consideration – business transactions	Involuntary disposal, similar replacement asset	Involuntary disposal, any replacement asset	Voluntary sale, with reinvestment	Death, qualifying illiquid asset	Gift, qualifying illiquid asset	Death, other asset, to spouse/ partner	Death, other asset, to other person	Gift, other asset	Relationship property divisions
Ability to pay tax	No – suggests a case for rollover	Yes	Yes	Yes	No – suggests a case for rollover	No – suggests a case for rollover	Yes[i]	Yes[i]	Yes[ii]	Mixed (depends on liquidity of asset)
Accurate valuation	No – suggests a case for rollover	Yes	Yes	Yes	No – suggests a case for rollover	No – suggests a case for rollover	Yes	Yes	Yes	Mixed (depends on liquidity of asset)
Taxing event within taxpayer's control	Yes	No – suggests a case for rollover	Mixed[iii]	Yes	No – suggests a case for rollover	Yes	No – suggests a case for rollover	No – suggests a case for rollover	Yes	Mixed
Secretariat recommendation	**Rollover**	**Rollover**	**No rollover**	**No rollover**	**Rollover**	**No rollover**	**Rollover**	**No rollover**	**No rollover**	**Rollover**
Loss ring-fencing	**Required**	**Required**			**Not required**		**Not required**			**Not required**

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i The tax liability will effectively be borne by the beneficiaries to the deceased's estate, who should be able to pay the tax by selling off part of, or borrowing against, any asset they receive from the estate.

ii If assets are divisible, the donor could be expected to sell off part of their assets to meet the tax liability. Alternatively, if the liquid asset is not readily divisible (e.g. rental property), it could be expected that a donee of a gift substantial enough to raise 'ability to pay' issues could help meet the donor's tax liability by borrowing against the asset if required

iii If rollover treatment is given for involuntary events where the taxpayer acquires a replacement asset, the taxing event in this case will be in the taxpayer's control as it will be triggered by the taxpayer's decision not to acquire a similar replacement asset.