Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

February 2019

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

Minutes

Date: Friday 12 October 2018

Location: The Treasury, No 1 The Terrace

Attendees: Sir Michael Cullen (Chair), Geof Nightingale, Hinerangi Raumati-Tu'ua,, Kirk Hope, Michelle Redington, Nick Malarao, Robin Oliver, Craig Elliffe, Marjan van den Belt, Bill Rosenberg
Independent Advisor: Andrea Black
Secretariat: Matt Cowan, Samantha Aldridge, Paul Kilford, Steve Mack, Matt Benge, Michael Sherwood (Note taker), Emma Grigg, Phil Whittington, Gordon Witte, Casey Plunket, Fiona McCarthy, Peter Frawley, Geoff Leggett

Apologies: Joanne Hodge

1. Administration

Noted	• Noted minutes for previous meeting. • Possible issue with page 3 excluded home section, which notes agreement to take a valuation approach for changes in use. • Will revisit, including whether to take a pro rata approach instead in today's Valuation discussion.
Actions for the Secretariat	• Issue to be discussed in later paper

2. RFRM

Noted	• RFRM revenue estimates in the paper, 3.5% rate is strongly positive for revenue. • Note the positives and negatives of the RFRM approach discussed in the officials' paper • Noted the difficulties in determining what rate should apply. • Could call it something other than RFRM if using a higher rate than 1.7%. One option is Fair Return Rate. • If we tax higher than the risk free rate, then not doing what the tax is supposed to be doing • Issue as well of taxing labour income too low if that labour is used to generate a capital gain e.g. doing up a house. • Provides people with a certain tax rate when choosing to invest in rental properties

	• RFRM rate might look cheap in areas with high levels of house price growth, but expensive in areas with little growth. • RFRM should not have an impact on debt loading, as already get interest deductions, and RFRM will only tax you on equity. • Open question of whether RFRM does creates a disincentive to spend on repairs and maintenance – secretariat to see if MBIE have done any work on landlord behaviour re: repairs and maintenance. • Incidence of the tax, would an RFRM impact rentals more than a realised taxation of capital gains? Secretariat to look at this. • Expect RFRM to have an impact on house prices, as the future tax cost is incorporated into the value of the house. Not clear is this is greater than the effect that an extended taxation of capital gains would have on prices. • Taxing net equity is like taxing the gross equity and allowing deductions for interest, if interest deductions were at the RFRM rate. • Would this RFRM approach also apply to investment in equities, as well as residential property? What would be the impact on capital flows for NZ? • Lack of horizontal equity in RFRM. Someone with a large capital gain on a house would pay the same as someone that makes a loss, if the cost of the house was roughly the same at the start. • Could also have a backstop of a bright line test to capture short-term capital gains. The goal of a hybrid approach would be to address under taxation of rental market, but still address the issue of incentive to make short term investments for capital gains • Social housing (Housing NZ) excluded from this rule, not currently in these numbers
Agreed	• A second RFRM paper is required to look at this option in more detail.
Actions for the Secretariat	• Managed funds paper to look at how to apply FDR to managed funds. Potentially looking at how it could apply to non PIEs as well? • Talk to MBIE about current incentive to non-invest in repairs and maintenance. Look at what effect RFRM might have on this • Provide RFRM numbers if baches are excluded • Explore the effect that RFRM would have on rents. Compare with the realised taxation of capital gains. • Second paper to look at modified "Fair Rate of Return Method" system that tries to capture group discussion.

3. Rollover and Ring-fencing

Noted	**Death as a Realisation Event** • Every country provides some form of rollover on death. Question of what degree of relationship we allow rollover to be given. Spouse and partner is clear. Property passed to next generation is less clear. • Issue of what sort of property gets rollover. Liquid vs illiquid question. If there is a distinction, possible that high wealth people are able to get better access to rollover by investing in illiquid, but tougher rule on investors in NZ shares. Distributional effect of rollover on death. Most of the benefit would be to families with more wealth

	• Could allow tax liability to be spread over a number of years, rather than full rollover. This would solve some of the illiquid asset issues • Noted the significant lock-in effect if wide rollover is granted • Mixed views on whether this rollover should also apply to gifts made during the person's life as there is a trade-off between economic efficiency and tax integrity concerns. • Option to look at is a threshold or lifetime cap over which rollover on death (and gifting) does not apply **Rollover Non-Death** • Rollover when no change in economic owner makes sense. However, there is a possibility that allowing rollover when putting assets into a company could be used as a way of avoiding the liquid illiquid distinction for death rollover. (Depends in ultimate decision as to rollover on death). May need to further develop these rules – e.g. look at Australia's scrip for scrip exchange rules. • Need to consider how the concept of no change in economic owner applies to Iwi-Hapū relationship. • A separate issue for replacement assets, selling an asset to purchase a new, possibly more expensive asset. Example discussed of a farmer upgrading from small to large farm • Question of how far to allow this type of rollover. Operates on a continuum. • There may be an economic benefit to allow limited rollover for business assets. But there is a risk that the tax is never paid. • Limited rollover also creates lock in to the same business if you can only reinvest in the same type of business asset. Might not be efficiency enhancing. • Environmental impact of granting rollover relief, giving more of an incentive to grow and create more environmental negative impact. Locking people into environmentally inefficient types of business e.g. dairy farming, instead of switching to more environmentally efficient businesses. Could consider rollover for reinvesting in more green businesses, changing business type. • If someone sells an asset and reinvests less than the full amount, then tax would apply only to the bit that is not reinvested • Longer term thinking, more rollover locks people in, makes it harder for long term changes to the structure and balance of the tax system • Consider using a small business exemption (*de minimis*) as an alternative option to providing rollover on voluntary sale and reinvestment in replacement assets. **Ring-fencing** • More rollover means more ring-fencing, which loses some of the benefit of extending the taxation of capital gains, such as the benefit of capital losses to those entrepreneurial people taking risks and simplicity benefits from removing the capital/revenue distinction. Part of the justification for taxing at full marginal rate. • Consider what mix of ring-fencing or specific avoidance rules are best for addressing integrity concerns
Agreed	**Death (rollover relief with no cost basis uplift)** • If roll-over on death is allowed for property passed to family members it should be allowed for property passed to any person. • No agreement on extent of rollover. Some members in favour of full rollover on death for all assets, some in favour of only relief for illiquid.

	• Support depends on if treatment of gifts follow death. More in favour of rollover on death if gifts don't follow, otherwise the hole is too big. • If there is broad rollover, will look at a potential cap for the excluded home, and lifetime cap for inheritance and gifting • Look at possibility of a cap based on asset value, or a lower cap based on actual gains. • No rollover granted once over cap. This includes illiquid assets • Providing some sort of spreading of the tax liability over several years if inheritance or gifting of illiquid business is over the cap. More work to come on this There should be a comment in the final report that the Government could rethink issues around inheritance tax if they wished in order to address intergenerational transfers **Non-death rollover relief** • Full rollover on gifts between spouses • Consider using a small business exemption (*de minimis*) as an alternative option to providing rollover on voluntary sale and reinvestment in replacement assets • Full rollover if no change in ownership in substance • Majority of the Group agreed that there should be rollover provided for compulsory acquisition by Crown and insurance proceeds that were reinvested into similar assets.
Actions for the Secretariat	• More work on cap on rollover for death / gifting. Should also consider rules for spreading the tax liability over several years when cap is exceeded on death. • Come back on what effect that broad rollover relief for death would have on the fiscals • Look at a small business *de minimis* in relation to extended tax of capital gains • Come back on idea of both annual and lifetime exemptions • Consider what mix of ring-fencing or specific avoidance rules are best for addressing integrity concerns • Report back on impacts on Māori collectively owned assets and how these should be treated

4. Transition at 1 April 2021

Noted	<u>**Valuation**</u> • Multiple options for how valuation day could work • Refer to a concept of value, as used in other places in tax legislation • Supplement with IR guidance around how taxpayers could value their assets • Compliance cost involved if require valuation around valuation day. Compliance cost is better to allow low-compliance cost valuation methods, such as before or after RV/QV to be the value. • Also note the issue with setting a prescribed method that results in undervalue. Would be unfair to taxpayers to do this. • Options approach provides more fairness • Any issue of extra investment is already dealt with by adding the cost to the cost basis of the asset

	<u>Median rule</u> • Smooths out paper gains or losses that never really made • Allows taxpayers to use pre-valuation day loss against post valuation day gains • Eliminates a loss when artificially high valuation • However there is an issue of how to deal with listed shares. Should they be included in the median rule? • Incentive to sell and rebuy shares if shares are higher than cost price on valuation day, but if at lower than cost, use the median rule. • Also, difference in treatment of median rule for property PIE, because median rule for holding property directly. • Shares are easier to value though, so arguably less need for the median rule. • Valuation of shares are not always clear though e.g. if you have a large holding. • Not allowing listed shares to use the median rule, however, means that paper gains will be taxed. **<u>Excluded home coming in and out of the base</u>** • Valuation approach vs straight line apportionment • Use RV before or after as the valuation as an option as well, or get your own valuation • Give taxpayers options • No median rule
Agreed	• Need the valuation option as an alternative for housing. Allow taxpayers to choose from multiple options. • Just take market value on shares as at valuation day • Use the median rule for all other assets **<u>Excluded home coming in and out of the base</u>** • Valuation approach vs straight line apportionment • Use RV before or after as the valuation as an option as well, or get your own valuation • Give taxpayers the option of that valuation approach, or taking a straight line apportionment • No median rule in this situation
Actions for the Secretariat	• To talk to LINZ, QV and valuers to get better understanding of methodology, make sure the proposed methods for valuing property are fair. • To look more at what rule should apply for property PIEs • Process for final text part of report - will be recirculated to the Group as a sense check to make sure the decisions are agreed with. Put text into a single document • Andrea's comments/changes will also be incorporated • There should be cultural diversity in names for examples

5. Intangibles and Sales of Business

Noted	• Options of specific exclusions from a wide definition, vs a discrete list • Discrete list creates issue of future proofing

	• Difficulty though in defining what is an "intangible" for the broad definition.
	• Could have an inclusive definition, such as all choses in action, saying it excludes specific things
	• If something can't be enforced in court, it should not be in the net.
	• Last bullet point in inclusive definition could be "any other legally enforceable right."
	• Issue with Māori cultural assets, depends if they are tradeable/enforceable
	• Fishing quota, issues with a closed market for Maori fishing rights, can only sell to other Iwi.
	• Assets like a chose in action of a personal nature. Avoid including these types of assets in the base. In line with general personal assets rule.
	• Discussion on applying median rule to these types of situations e.g. fishing quota with no purchase price. Always just end up applying value on valuation day or sale price.
	• Note implications for existing asset disposal rules. Question of whether these rules should be rationalised and brought into the more comprehensive tax on capital gains. For example, the following are already treated as being on revenue account::
	  o Emissions Trading Scheme units
	  o Financial arrangements, essentially financial instruments
	  o Forest cutting rights.
	• R&D tax incentive would not be clawed back by a more comprehensive tax on capital gains. Would tax income from R&D and shareholder disposal gains, but not the same as clawing back.

Agreed	• Agree to wide definition with a list of what is excluded, but not an exclusive list • Agree with officials looking at how existing rules could be brought into a more comprehensive taxation on capital gains, if possible or desirable. • Agree that there is no issue with R&D
Actions for the Secretariat	• Commercial lawyer to look at list of personal chose in action

6. Social Policy

Noted	• Need to decide how to treat capital gains and losses for the purpose of determining WfF entitlements, student loan repayment obligations, and child support payments. • Unsymmetrical treatment of capital gains and losses does not seem fair on the face of it. • However, WfF is about looking at ability to meet your costs, rather than the economic definition of income. People with capital losses but large salary income can still meet their own expenses • The tax system has already given a benefit to those with capital losses by offsetting against other income (presuming no ring-fencing) • Current tax system already disregards other losses when determining welfare

	• Increase lock-in to release capital gains until after your children are 18 • Part of issue is that WfF looks at income, but not net assets • Policy decision by government to give support based on annual income, Could choose disregard lumpy capital gains and losses • Checked with WEAG to see if any thoughts on this paper, but they had no comments. • Possibly an argument for a different treatment of WfF, and child support/student loan repayments • With a capital gain, you have access to the cash. If you have a capital loss, you don't have a decrease in ability to pay. Can still pay out of salary and wages. • WfF, possibly not many people with significant capital gains but also low enough income to get WfF
Agreed	• Student loan repayments should take into account capital gains, but disregard any losses • Child support should take into account capital income as well, and also disregard any losses • WfF should take into account capital income when determining entitlements, but capital losses should have no effect. If this asymmetry is not possible, then the second best option would be to exclude both capital gains and losses. • These decisions should be expressed as there being no change to the status quo for treatment of gains and losses on revenue account property.
Actions for the Secretariat	• Keep in mind impact that these changes would have on payroll compliance costs for companies.

7. Administration Considerations

Noted	• Note officials' paper looking at interrelationship between third party reporting, withholding, provisional tax etc. and effect that an extended taxation on capital gains would have on this. • Officials to consult on whether information reporting or withholding is appropriate in various circumstances for enforcing a more comprehensive tax on capital gains. Could be that different treatment is warranted for different assets. • Already have some rules in place for non-residents selling property. Have some options for how to determine how much to be withheld • For other assets like shares, could require the share registry to inform IR about sales. • Reluctant to have withholding in share market, due to impact on liquidity • Should not underestimate the compliance cost that withholding and information reporting has on the companies carrying that out. Should try and help out those companies in other areas. • Some countries give companies an administrative fee to compensate for cost of compliance. • Difficulty (currently) in determining if self-assessment that a home is an excluded home is accurate, so don't know if to provide information (this refers to brightline rule).

	• Could require a taxpayer to fill out a form at every sale, match to IRD number. Taxpayer states if the sale if an excluded home, but IR can follow up on that later to check. • One-off capital gains should not put you into provisional tax. • Also puts you in UOMI regime. • But, system needs to be flexible enough to deal with this, get a re-estimation - not just take capital gains out. • Cost base information. Issues with keeping track of what the cost base is when improvements are made to an asset. When should the information about extra capital expenses be provided to IR? • Could just require some information being provided, but doesn't have to be a full tax return. Charity receipt example of just taking a picture. • If information is not provided, puts IR at a disadvantage, hard to determine what the cost basis should be. • Still allow people to leave information reporting to the end, but need to keep in mind the integrity risk. Higher burden on the taxpayer if information not provided within the year the capital expense occurred. • Currently don't require a company to provide list of fixed assets every year, but have self-assessment instead. But, a more comprehensive taxation of capital gains would bring more taxpayers who are less sophisticated into the system. Having them provide information as capital expenses occur, creates a discipline
Agreed	• Comfortable with withholding and information reporting in some circumstances • For provisional tax issue, don't just take capital gains out of provisional tax. Just leave in ordinary rules, but make sure that the provisional tax rules are flexible enough to deal with lumpy payments. • Secretariat does not need to bring back a more detailed paper on admin considerations. But withholding tax ideas should be brought to the Group.
Actions for the Secretariat	• Draft for what to include in the report to be created for this. Put to the Group • The Group is especially interested in any recommendations around withholding.

Discussion at the end:

- Ideas from targeted consultation - need to make sure there is an ability to consider those.

- More data on high wealth individuals. Secretariat will talk to StatsNZ

- Fiscal stabiliser effect of tax in general, as well as on an extended taxation on capital gains specifically. This work is coming, and will be in the two packages papers.

- Can look at changing different rates and thresholds, with some increases? Decrease first rate, but increase rate of second threshold

- To come back with more on what possible lifetime and annual caps could look like (paper for 22-23 Nov meeting)

- Look at what recommendations could come into effect on 1 April 2021, and what parts would require deferral of a year so businesses can get ready to comply.