Tax Working Group
Te Awheawhe Tāke

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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.

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

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Coversheet: International Issues

Position Paper for Session 22 of the Tax Working Group
8-9 November 2018

Purpose of discussion

The purpose of this paper is to provide advice to assist the Group with decisions on the international aspects of taxing capital gains more comprehensively.

It also proposes draft text for inclusion in the Final Report (Appendix A).

Key points for discussion

This paper discusses:

a. whether deemed disposals when a taxpayer ceases to be tax resident in New Zealand should:
   i. apply to all taxable assets held by the taxpayer;
   ii. be made optional; or
   iii. be subject to a *de minimis* threshold;

b. if the deemed disposal is not made optional, whether taxpayers should be able to defer payment of tax resulting from a deemed disposal on emigration, and if so, in what circumstances;

c. if the deemed disposal is not made optional, whether taxpayers should be able to unwind tax on a deemed disposal on emigration, if they subsequently become tax resident again holding the asset in the same capacity;

d. whether the cost base of an asset that enters the tax base on immigration should be the market value of the asset at the time the asset owner becomes tax resident in New Zealand;

e. the taxation of foreign investment funds (*FIFs*), namely:
   i. whether the fair dividend rate (*FDR*) should be lowered;
   ii. whether FDR should apply on a net basis (instead of gross); and
   iii. whether the comparative value (*CV*) option for natural persons and family trusts should be removed;

f. reasons for and against exempting foreign homes and rental properties owned by New Zealand tax residents.

Recommended actions

We recommend that you:

a **agree** that the deemed disposal on emigration should be limited to assets that cease to be liable to tax when a person ceases to be tax resident

b **agree** that the deemed disposal on emigration should not be made optional

c **agree** that payment of tax on a deemed disposal can be deferred in certain circumstances and with conditions

d **agree** that a *de minimis* should apply to the deemed disposal on emigration if it results in capital gains of less than $15,000

e **consider** if temporary emigrants should be allowed to "unwind" a deemed disposal if they subsequently become New Zealand tax resident again, while holding the same asset in the same capacity

f **agree** that the cost base of an asset that enters the New Zealand tax base when the asset's owner establishes tax residence should be the market value of the asset at the time

g **note** that there are reasons for and against making changes to FDR taxation, particularly the 5% rate

h **note** there are reasons for and against taxing Australian shares under the FIF regime

i **agree** for changes to the FIF regime to be considered further under the Generic Tax Policy Process (*GTPP*)

j **agree** that whether foreign homes or foreign rental properties owned by New Zealand residents should be excluded from the tax base should be considered further under GTPP

k **agree** to the Final Report text attached to this paper.

International issues

Position Paper for Session 22
of the Tax Working Group

November 2018

Prepared by the Inland Revenue Department and the Treasury

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Executive Summary

This paper discusses the international aspects of taxing capital gains more comprehensively. The first half of the paper discusses, at a high level, the tax treatment that should apply when an individual taxpayer ceases to be tax resident in New Zealand ('emigration'), and when an individual taxpayer brings taxable assets into the New Zealand tax base by becoming tax resident in New Zealand ('immigration').

The Group's interim decision in the Interim Report was that an emigrating taxpayer should be deemed to have disposed of their taxable assets for market value on the day they cease to be tax resident in New Zealand. If there was no deemed disposal, New Zealand could lose taxing rights over the assets. The reasons for deemed disposal on emigration do not apply to New Zealand land and assets attributable to a New Zealand permanent establishment (*PE*), which remain in the New Zealand tax base even if they are owned by a non-resident. The Secretariat therefore recommends that the deemed disposal on emigration should not apply to New Zealand land or PE assets.

As a deemed disposal would create a tax liability at a point where taxpayers may not have the cash flow to pay the tax, the Secretariat recommends that taxpayers should be able to defer payment of tax in certain circumstances, with conditions. We also suggest a *de minimis* threshold of around $15,000 of capital gains, under which deemed disposals would be ignored. The Group may also wish to consider whether temporary emigrants should be given an ability to unwind a deemed disposal, if they subsequently return to New Zealand holding the same asset in the same capacity.

Similarly, a taxpayer should be deemed to have disposed of their taxable assets for market value immediately before they become New Zealand resident ('market value option'). Other options considered for establishing a cost base on immigration were original cost, median rule, and straight-line apportionment. The Secretariat considers the market value option is most consistent with all of New Zealand's double tax agreements (*DTAs*). It is also required by several DTAs, notably the ones with Australia and Canada.

The second half of the paper discusses the taxation of foreign investment funds (*FIFs*) and foreign homes and rental properties owned by New Zealand tax residents. The paper outlines reasons for and against lowering the foreign dividend rate (*FDR*), which is currently 5%, and including Australian listed shares in the FIF regime. The paper also discusses reasons for and against exempting capital gains from the sales of foreign homes and rental properties from the tax base. All of these issues involve difficult competing considerations and do not seem to be central to the Group's decision on whether or not to recommend that capital gains be taxed more comprehensively. The Secretariat therefore recommends that these issues be considered further under the Generic Tax Policy Process (*GTPP*).

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 on the tax consequences of:

    a. **Emigration**. Where a taxpayer ceases to be tax resident in New Zealand while holding taxable assets (including situations where a taxpayer becomes non-resident under a treaty).

    b. **Immigration**. Where a taxpayer realises assets they acquired before they became tax resident in New Zealand.

    c. **Foreign investment funds (*FIFs*)**. A number of issues need to be considered, including the fair dividend rate (*FDR*) option, and whether the comparative value (*CV*) option for natural persons and family trusts should be retained in its current form.

    d. **Foreign homes and rental properties held by New Zealand tax residents**. Whether these should be excluded from the base.

1.2 Content and scope

2. The Group has already made several decisions on the international aspects of taxing more capital gains and these are briefly summarised in **Appendix B**. Therefore, this paper is focussed on the issues highlighted in the Interim Report as requiring further consideration by the Group.

3. The Secretariat recommendations in this paper are similarly intended to establish high-level principles, but there are also some areas where we consider that the general principles may need to be supplemented or deviated from (e.g. employee share schemes, disposal of ships and aircraft).

4. The migration chapters are focused on the migration of individuals, and do not discuss the migration of companies (for which there are existing migration rules), trusts, or other non-natural persons. If capital gains are taxed more comprehensively, these rules may need to be reviewed under the Generic Tax Policy Process (*GTPP*) to ensure they are broadly consistent with the rules that apply to migration of individuals.

5. References in this paper to 'resident' and 'non-resident' are intended to refer to a person's tax residence rather than their immigration status. Notwithstanding, the tax residence rules may need to be adjusted to ensure that they are workable in this context.

2. Emigration

6. In Appendix B of the Interim Report, the Group explained that if no tax is imposed when a person terminates their New Zealand tax residence, emigration would be a way to avoid a realisation-based tax on capital gains other than in relation to New Zealand land. It proposed an option to prevent this by deeming assets to be disposed of for market value upon the asset owner's emigration.

7. This Chapter addresses two questions raised by the Group about emigration:

    a. whether a deemed disposal should be limited to those assets that cease to be subject to tax on sale when a person becomes non-resident; and

    b. whether a deemed disposal should be made optional, as in Australia.

8. The Secretariat notes that any design of rules intended to deem assets to have been disposed of on emigration will also need to take into account assets held on trust. For instance, if a person settles foreign assets on a trust while New Zealand resident and then emigrates, trustee income arising from sales of those assets will generally not be taxable. Accordingly, it may be necessary to deem these assets also to be disposed of on emigration. This Chapter is more concerned with the fundamental principles and so does not consider issues raised by trusts.

2.1 Whether deemed disposal should be limited to assets that cease to be subject to tax when a person becomes non-resident

9. In Appendix B of the Interim Report, the Group considered if:

> Deemed disposal could be limited to those assets that cease to be subject to tax on sale when a person becomes non-resident. So, for instance, it might not apply to ownership of land in New Zealand but would apply to ownership of land outside New Zealand.

10. As recognised by the Group, the reason for the general 'deemed disposal' rule is because, without such a rule, a realisation-based tax may be avoided for the following reasons:

    a. **Loss of taxing rights.** For some assets (e.g. shares in a New Zealand company), New Zealand loses taxing rights if the taxpayer migrates to a country with which New Zealand has a double tax agreement (*DTA*). For other assets (e.g. shares in a foreign company), New Zealand may lose taxing rights even if the taxpayer migrates to a country without a DTA if income from the sale of the asset would not have a New Zealand source.

       The Secretariat notes that, if capital gains are taxed more comprehensively, the domestic source rules[1] should be reviewed to ensure that they adequately cover capital gains in New Zealand.

[1] In section YD 4 of the Income Tax Act 2007.

b. **Practical ability to enforce compliance**. When a taxpayer leaves New Zealand, Inland Revenue's practical ability to audit them and enforce compliance is reduced. However, New Zealand is increasingly entering into Assistance in the Collection of Taxes (*AinC*) provisions in our DTAs whereby New Zealand may request the treaty partner country to collect outstanding New Zealand tax debt.[2] It should be noted though that relying on AinC provisions is a backstop rather than an effective collection mechanism.

11. These two reasons are less likely to apply to New Zealand real property (land) and assets forming part of the business property of a New Zealand permanent establishment (*PE*).[3] As is standard in DTAs, New Zealand retains taxing rights over its real property and PE assets in all of its DTAs.

12. Other countries that have a deemed disposal rule on emigration, including Australia, Canada and South Africa, exclude their real property and PE assets from the deemed disposal rule.

13. In any event, it would be important to ensure that, under a more comprehensive tax on capital gains, the existing resident land withholding tax (*RLWT*) rules will be expanded to include all New Zealand real property sold by a non-resident. This would give New Zealand the practical ability to enforce compliance for gains on real property.

Secretariat recommendation

14. Provided the RLWT rules are extended to include all New Zealand real property sold by a non-resident, the Secretariat recommends that the deemed disposal on emigration should not apply to New Zealand real property.

15. The Secretariat also recommends that the deemed disposal on emigration should not apply to assets forming part of the business property of a New Zealand PE.

16. We also note for completeness that any assets taxed on accrual but not on realisation, such as FIFs and possibly KiwiSaver and listed PIEs holding shares, should also be excluded from the deemed disposal rule.

2.2 Whether a deemed disposal should be made optional

17. In Appendix B of the Interim Report, the Group considered if there were some cases where the general 'deemed disposal' rule should not apply:

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2 Such provisions were introduced into the *OECD Model Tax Convention on Income and on Capital* (the blueprint for all DTAs) in 2003. So far, they have been included in New Zealand's DTAs with Australia, Canada, Japan, the Netherlands, Turkey and the United Kingdom. It will appear in more DTAs as negotiations for new and replacement DTAs continue. Significantly, the *Multilateral Convention on Mutual Administrative Assistance in Tax Matters* (the MAC), that NZ signed in 2012, also establishes AinC (unless a party reserves against it). To date, the MAC has been signed by 125 jurisdictions, and is currently in force for 109 of these (though around half of these jurisdictions have reserved against AinC).

3 Including in some cases, shares in a company whose value is mostly attributable to New Zealand land.

We are considering whether a deemed disposal could also be made optional, as we understand is the case in Australia, so that a natural person migrant could elect to remain taxable with respect to the asset. For that person the asset would remain an included asset and the person would be taxable in New Zealand on it for the full gain on sale. This protects temporary migrants from being taxed on assets when they leave and then return still holding the asset. It also better provides for the avoidance of double tax on the same income by use of double tax agreements.

18. A deemed disposal could be undesirable in cases involving:

    a. **Temporary emigration.** Where a taxpayer becomes a non-resident for a short period but becomes resident again holding their same assets in the same capacity, the assets ultimately remain in New Zealand's tax base. A deemed disposal on emigration would therefore be an unnecessary compliance burden for the taxpayer.

    b. **Certain illiquid assets**. Where a taxpayer emigrates holding certain illiquid assets (e.g. an operating business), a deemed disposal could cause cash flow and valuation issues. However, in some cases when a taxpayer emigrates holding the assets of an operating business, the business may be a New Zealand PE (and so there may not need to be a deemed disposal).

    c. ***De minimis* amounts of tax**. Where a deemed disposal would only result in small amounts of tax, the compliance costs of a deemed disposal to the taxpayer and to the Commissioner may outweigh the amount of tax revenue that could be collected.

19. However, any rules addressing concerns over temporary emigration or illiquid assets should take care not to undermine the general rule. As noted above, the reason for the general rule is to protect New Zealand's tax base.

Australian approach

20. The Group has suggested making a deemed disposal optional, as is the case in Australia.

21. Australia's approach is set out in more detail in **Appendix C**. In summary, at the time a resident taxpayer becomes non-resident, they are essentially treated as having sold for market value any taxable assets that they hold, other than taxable Australian property (*TAP*). TAP broadly consists of Australian real property and assets attributable to an Australian PE.

22. Individuals have the option of deferring a deemed taxable gain/loss on their non-TAP assets by electing for all their non-TAP assets to be treated as TAP. Such assets are referred to as 'deemed-TAP' assets. If the person becomes resident in

Australia again before they have realised a deemed-TAP asset, the deemed disposal is effectively unwound.[4]

23. However, if a person makes this election and realises a deemed-TAP asset while they are a non-resident, they are required to file a tax return with their taxable gain/loss with the Australian Tax Office (*ATO*).[5] If the taxpayer does not file a return, the ATO has very little way of detecting or enforcing this. In the course of reviewing the individual tax residence rules, the Australian Board of Taxation noted:[6]

> Since it is acknowledged that a negative cash-flow impact is associated with any 'deemed' disposal, a taxpayer may make the choice to defer any deemed gain or loss until ultimate disposal. Mechanically, this is achieved by deeming a non-TAP asset to constitute TAP and relying on the (now foreign resident) taxpayer to subsequently furnish their income tax return in Australia disclosing the disposal. The likelihood of this occurring was questioned during consultation, with the general view being that a revenue leakage is more likely than not to arise.

24. Moreover, if the taxpayer becomes resident in a country with which Australia has a DTA, the DTA may prevent Australia from taxing capital gains on disposal of deemed-TAP assets despite the taxpayer's election. This is the case with Australia's treaties with both the United Kingdom and United States. The Board of Taxation has suggested that these rules may need to be reformed.

25. The Secretariat does not recommend following the Australian approach, as it seems to have undermined the reasons for, and compliance with, their general deemed disposal rule. The Secretariat suggests two alternatives for dealing with temporary emigration and illiquid assets, based on the Canadian approach. Canada's approach is set out in **Appendix C**.

Alternative approach for temporary emigration – unwind on return

26. An alternative to making a deemed disposal optional is to allow taxpayers to 'unwind' a deemed disposal from emigration if they subsequently become tax resident in New Zealand again. This is the approach adopted in Canada.

27. The 'unwind' should apply to liability for the core tax and any resulting interest or penalties, so that the taxpayer is put in the same tax position they were in as if they had never emigrated. The 'unwind' should only be allowed if the taxpayer still holds the relevant asset in the same capacity when they become New Zealand resident again.

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4 The person is effectively treated as having acquired the asset on its original acquisition date for its original cost. This overrides the ordinary rule that deems an immigrating taxpayer to have acquired their property for market value on the day they become tax resident.

5 Note that gains after 8 May 2012 will not be eligible for the 50% CGT discount, as the discount is no longer available to foreign residents.

6 Australian Board of Taxation Review of the Income Tax Residency Rules for Individuals (August 2017) at [1.288].

28. Even if the taxpayer has an ability to 'unwind' a tax liability on return, payment of the tax on emigration should still be required by the ordinary due date, unless the taxpayer is permitted to defer payment (discussed in the next section). If a taxpayer has paid a tax liability that is later unwound, the tax paid could be credited to a later income year or refunded if the taxpayer has no outstanding tax liabilities.

29. Inland Revenue generally only keeps tax collection records for 10 years, unless there are special circumstances (for example, an ongoing investigation). The Secretariat therefore suggests that any unwind should be subject to a time limit of no more than 10 years.

Alternative approach for addressing cash flow issues – crystallise liability, defer payment with conditions

30. Where a taxpayer emigrates, it may be appropriate to allow payment of any resulting tax liability to be deferred until the earlier of when the property is sold, or a defined period. The Secretariat recommends that deferral be restricted to illiquid assets only on the basis that cash flow issues only arise with illiquid assets such as unlisted shares.

31. Conditions of deferral may be required to ensure that New Zealand's tax base is adequately protected. Some conditions could include:

    a. Requiring the taxpayer to file a return/disclosure statement and provide Inland Revenue with a list of all illiquid assets on which tax has been deferred, including each asset's base and estimated market value on the date tax residence ceases. A similar return is required in Canada. This could be refreshed annually.

    b. Requiring the taxpayer to provide security to Inland Revenue if the amount of tax being deferred exceeds a specified amount. Again, this is required in Canada.

    c. Limiting the period of deferral to a fixed number of years.

    d. Charging interest on the deferral.

32. The Secretariat recommends that any conditions of deferral be determined following consultation to ensure that they are workable for taxpayers (but still protect New Zealand's tax base).

De minimis *for small amounts of tax*

33. The Group may wish to consider a *de minimis* threshold, under which a deemed disposal on emigration would be ignored.

34. The Secretariat recommends a *de minimis* based on the size of gain that would otherwise arise on the deemed disposal.

35. As people can become non-resident and resident again multiple times in their lives, the *de minimis* should be sufficiently low that taxpayers would not bother using it to avoid tax on capital gains. If the deemed disposal on emigration results in capital gains for the taxpayer that, in total, exceed the *de minimis* threshold, all of the gains should be taxable. A suggested threshold is capital gains of around $15,000.

36. For reference, Canada requires emigrating taxpayers to attach a list of all their property to their tax return (excluding personal-use property valued at less than $10,000), if the fair market value of all their property is over $25,000. (As personal-use property would not be taxed in New Zealand, there would be no need to list that property.)

Secretariat recommendation

37. The Secretariat does not recommend generally making a deemed disposal optional.

38. The Secretariat notes that, if the Group is concerned about temporary emigration, it could consider giving taxpayers an ability to "unwind" the original deemed disposal if they later become tax resident in New Zealand again while holding the same assets in the same capacity. If there is an ability to "unwind" the tax, the Secretariat recommends that it be subject to a time limit of no more than 10 years.

39. The Secretariat recommends that taxpayers who emigrate while holding certain illiquid assets should be allowed to defer payment of their resulting tax liability for a defined period, if certain conditions are met.

40. The Secretariat recommends a *de minimis* threshold for capital gains of less than $15,000.

3. Immigration

41. In Appendix B of the Interim Report, the Group noted that when a person becomes a New Zealand tax resident, taxable assets that they hold will enter the tax base. The Group proposed that, consistent with existing law, such assets should enter the tax base at their market value on the first day the asset owner becomes New Zealand tax resident (or, in the case of a transitional resident, becomes a resident who is not a transitional resident).[7]

42. The Group observed that:

> Because of the subjectivity inherent in valuations, where a valuation figure would produce a loss (i.e. is higher than actual sales), it may be desirable to either ring-fence that loss, or use the median rule, as we propose for transitional valuations ….

The extent to which losses are ring-fenced can be considered after the Group has made decisions on rollover.

43. Assets that may enter the tax base on immigration include New Zealand shares, shares in a CFC or goodwill and other intellectual property in an unincorporated business (if it does not form part of the business property of a foreign PE). This discussion does not apply to assets that do not enter the tax base on immigration (e.g. New Zealand real property and assets of a New Zealand PE), whose cost base will be determined under ordinary rules (typically original cost). We note that foreign superannuation schemes, financial arrangements, and FIF interests are subject to existing rules on immigration, and we do not propose to alter those.

44. The Secretariat has considered the following four options for establishing a cost base for assets that enter the tax base through immigration:

    a. Original cost;
    b. Market value on date the person becomes tax resident in New Zealand;
    c. Median rule; and
    d. Straight-line apportionment.

45. The Secretariat considers the market value option is the option that is the most principled and generally consistent with New Zealand's treaties. Under the market value option, the cost base of a taxable asset will be its market value on the date that the holder of the asset becomes tax resident in New Zealand.

46. While some of the other options (such as original cost and straight-line apportionment) have the advantage of potentially reducing compliance costs, they are not consistent with international norms and may cause treaty issues. The Secretariat does not recommend these as a primary option, but it is possible they

[7] For simplicity, this Chapter just describes people becoming tax resident in New Zealand, without referring to the transitional resident rules each time.

could be used as a supplementary option in some cases. The other three options are discussed more fully in **Appendix E**.

3.1 Advantages of a market value option

47. The market value option is principled in the sense that it only taxes gains that accrued during the time the asset owner was tax resident in New Zealand. It is the approach adopted by Australia and Canada (both of which tax deemed disposals on emigration) and is required by both the NZ–Australia and NZ–Canada DTAs. It is the only option that is not inconsistent with any of New Zealand's DTAs (i.e. even where a DTA does not require a 'step-up', the market value option will not be inconsistent with it).

48. It is also consistent with the current FIF rules for foreign listed shares that a taxpayer holds on immigration,[8] for financial arrangements, and for foreign superannuation.[9]

Example 1 – Migration from Australia, market value
In Year 1, Tom, an Australian tax resident, buys some Australian shares for $100.
In Year 3, Tom migrates to New Zealand. Tom ceases to be resident in Australia on the same day he becomes resident in New Zealand ('Migration Day'). The value of his shares is $150.
In Year 10, Tom sells the shares for their market value of $210. His actual capital gain is therefore **$110**.
The tax consequences for Tom will be:
• In Year 3, Tom is treated for Australian tax purposes as having a capital gain of **$50** (being $150 - $100).
• In Year 10, Tom will be treated for New Zealand tax purposes as having derived a capital gain of **$60** (being $210 - $150). This is consistent with the NZ–Australia DTA.
Overall, Tom has been taxed on his actual capital gain of $110 ($50 of which was taxed in Australia and $60 of which was taxed in New Zealand).

3.2 Possible disadvantages of market value option

49. The market value option may increase compliance costs as immigrants may have to obtain a valuation. However, the taxable assets that immigrants are most likely to bring into the New Zealand tax base which would require a valuation appear to be controlled foreign companies (CFCs) or unincorporated businesses (to the extent that those assets do not form part of the business property of a PE in another country). This would limit the number of people who may need a valuation.

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8 Under section EX 67 of the Income Tax Act 2007, when a person has a non-attributing interest in a FIF that and it becomes an attributing interest in a FIF there is a deemed sale and reacquisition at market value.

9 Lump sums are not taxed if they are received within 4 years of the taxpayer becoming a New Zealand resident, otherwise tax is based on a schedule or formula designed to approximate the same tax position as if they had transferred their superannuation to New Zealand when they first arrived and paid tax on investment gains as they accrued.

50. Another possible drawback of the market value option is that some gains may go untaxed altogether (i.e. double non-taxation) if the other country does not tax on emigration. However, this arguably is not a drawback if one considers that, in principle, New Zealand should only tax increases in value that accrued while a taxpayer was New Zealand tax resident.

Example 2 – Migration from the UK, market value

Assume the same facts as in Example 1. The tax consequences for Tom will be:

- There are no UK tax consequences as the UK does not generally tax assets on emigration.
- In Year 10, Tom will be treated as having derived a taxable capital gain in New Zealand of **$60.**

Overall, Tom has made an actual capital gain of $110, but only $60 has been taxed.

51. We also note that, although there may be some scope for taxpayers to inflate market values and therefore their cost base, such a risk exists under all four options, as taxpayers might also inflate their “original” cost. A market value is, at least in principle, an objective measure.

3.3 Secretariat recommendation

52. The Secretariat recommends that assets entering the New Zealand tax base on immigration should be deemed to enter at their market value at the time the asset owner becomes New Zealand tax resident.

4. Taxation of FIFs

4.1 Current rules

53. To simplify a great deal, foreign portfolio shares (other than Australian) owned by residents are taxed under the Foreign Investment Fund (*FIF*) regime. In general, the rule is that a 5% deemed return is applied to the total opening market value of portfolio shares. This is called the "Fair Dividend Rate" (*FDR*). Tax is then paid on that deemed return.

54. That general description ignores some complexity. There are special rules for shares bought and sold within a year, and for individuals, there is both a $50,000 cost basis *de minimis* (below which a taxpayer can return the dividends paid as income instead of the FDR system), and a method whereby if the shares return less than 5% over the year, the individual taxpayer can return the total actual change, with a minimum floor of $0 (the CV option for natural persons and family trusts).

55. The FDR system and the rate (5%) reflects a compromise and amalgam of a few different justifications. To examine those, this Chapter first looks at the underlying economic theory for why and how residents should be taxed on their foreign income on portfolio investments. The Chapter then briefly addresses the tax treatment of Australian listed shares.

4.2 Economic theory of taxing residents on foreign-sourced income

56. Foreign taxes are not directly relevant to the living standards of New Zealanders, while New Zealand taxes are, as they fund public goods and services, and transfers.

57. From this flows the general principle that New Zealand as a whole will be best off when New Zealand investors compare foreign investments after foreign taxes, with New Zealand investments before New Zealand taxes. Or in other words, when a New Zealand investor pays an equivalent domestic tax rate irrespective of where the income is sourced.

58. As a simple example, assume that the tax rate is 25% in each country. If an investment in a US company earns 10% before foreign taxes, but 7.5% after foreign taxes, and an investment in New Zealand earns 8% before New Zealand taxes, but 6% after New Zealand taxes, the investor will face the following situation:

	Before any taxes	Foreign taxes	Domestic taxes	After all taxes
Foreign investment	10%	2.5%		7.5%
Domestic investment	8%		2%	6%

59. Without New Zealand taxes on the foreign investment, the investor will prefer the foreign investment even though it only returns 7.5% for New Zealand overall, while the domestic investment returns 8%. If the assumed 25% New Zealand tax also applies to the foreign investment, then the situation that the resident faces will be:

	Before any taxes	Foreign taxes	Domestic taxes	After all taxes
Foreign investment	10%	2.5%	1.875%	5.625%
Domestic investment	8%		2%	6%

60. As domestic tax is applied on both foreign and domestic investment, irrespective of the investment choice the individual will pay taxes to fund New Zealand public goods and services.

61. Once New Zealand tax applies, the domestic investment is better for the investor after tax. Domestic taxes then increase not just because foreign investment income is taxed, but also because of a substitution towards domestic investment. This is an appropriate base for levying taxation, taking into account that New Zealand taxes pay for New Zealand public goods and services.

62. However, it is also true that this approach prevents capital being employed where it is most productive on a pre-tax basis. Allowing a credit for foreign taxes would achieve that outcome.

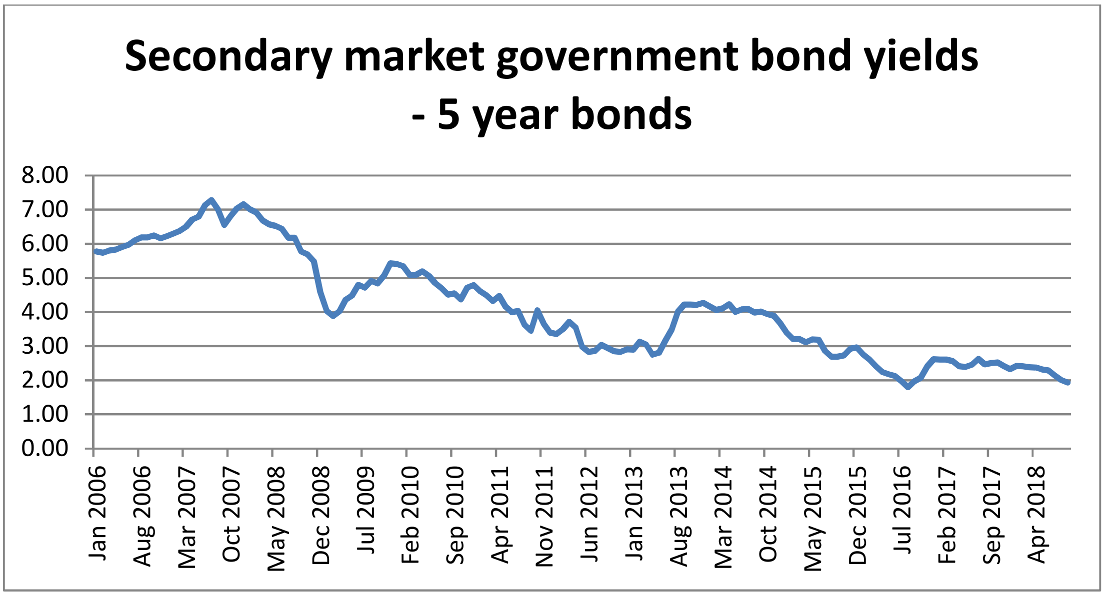
The FDR rate

63. The original problem identified was that because New Zealand had no capital gains tax, New Zealand residents owning foreign shares were only taxed on dividends. Because foreign shares usually had lower dividend yields than New Zealand shares (and correspondingly higher expected capital gains), the result was that less tax was paid on foreign shares than New Zealand shares, encouraging people to invest overseas, particularly in shares with low dividend rates.

64. The solution was a compromise that acknowledged the primary problem causing the different treatment was the lack of dividends paid on shares. The approach was to tax foreign shares at a deemed rate that was similar to the dividend pay-out rate of New Zealand shares, which was about 4.5% at the time. A rate of 5% was chosen for the FDR rate. There is also a theoretical equivalence between a comprehensive income tax that taxed accruing capital gains and the risk-free return method of taxation. (*RFRM*). If the FDR had been set at the nominal risk-free rate, then the RFRM tax would have solved the problem by taxing income on foreign shares in an equivalent manner to a comprehensive income tax on accruing gains.[10] In reality, for most of the history of the FDR since its inception in 2007 the rate

[10] See section 2 of the *Risk-free return method of taxation* paper from session 20 for an explanation of the equivalence.

has been above a nominal risk-free rate. The chart below shows the yield on 5 year government bonds (the shortest period for which there is full data from 2006):



The theory of RFRM is that taxing a risky investment at the risk-free rate should be neutral in terms of not distorting investors' investment decisions, just as is taxing all income comprehensively (including accruing capital gains).

65. In the *Risk-free return method of taxation* paper from session 20, the Secretariat raised questions about what the risk-free rate actually is and raised the question of whether 3.5% might be an appropriate level, given that is what people can earn in short-term fixed term deposits at banks. Other Group members had different views on what the true risk-free rate was, suggesting government bonds were the better estimate. 1-year, 2-year, and 5-year government bonds currently yield 1.71%, 1.67%, and 1.93% respectively.[11]

66. Average returns on foreign shares are higher than the risk-free rate. The Morgan Stanley Capital index shows an average annual return of 7.4% (inclusive of price appreciation and dividends) over the last 20 years. This means a low FDR rate may leave an impression of under-taxing foreign shares. However, if shares are taxed on an "expected" return basis, this could bias investment decisions away from investing in that asset class relative to a comprehensive income tax or risk-free return and would be a substantial disincentive to take risk. This is further explored in **Appendix F**.

67. If the rate were dropped then consideration would have to be given to taxing on a net equity basis (with interest deductions denied) rather than a gross basis (with interest deductions allowed). Otherwise, taxpayers may be able to borrow to invest

[11] https://www.rbnz.govt.nz/statistics/b2, accessed 25 October 2018

in shares and report tax losses because interest deductions were much higher than the deemed income.

68. Some people we have consulted with (managed funds advisors and Corporate Taxpayer Group) have indicated that if we change to taxing New Zealand shares on capital gains as well as dividends, while we continue to tax foreign shares on FDR, they would invest less in domestic shares and more in foreign shares than they do currently. They go on to say that this would have an adverse effect on New Zealand's capital markets.

69. Given the competing arguments for and against lowering the FDR rate, the Secretariat recommends that it be considered further under GTPP. We also note that lowering the FDR rate will be revenue negative.

70. If the rate is lowered, the Secretariat suggests that the concession described above at paragraph 54 be removed, so that regardless of whether an individual or trust makes a loss, it pays tax on a deemed return of the FDR. Similarly, it might be worth looking at whether foreign tax credits should be limited to the treaty withholding rate as a proportion of the fair dividend rate, rather than being unrestricted.

4.3 Exclusion of Australian listed shares from the FIF regime

71. The Group noted in its Interim Report that it seems appropriate to simply tax realised gains and losses for portfolio interests in Australian listed companies that are not subject to the FIF regime.

72. The Secretariat notes that there may be scope for reconsidering this decision if capital gains are taxed more comprehensively. One of the reasons why Australian listed shares were excluded from the FIF regime (and taxed in the same way as New Zealand shares) was, at the time the FIF regime was introduced, it was believed that New Zealand and Australia could agree to mutual recognition of imputation and franking credits. Exploring mutual recognition is now a lower priority than it was when the exemption was developed.

73. However, there are other reasons why it may be desirable to continue taxing Australian listed shares in the same way as New Zealand shares. Australian listed shares tend to have higher dividend yields than many other countries because of their franking system. Moreover, there are many individual investors that only hold Australian and New Zealand listed shares, and taxing Australian shares under the FIF regime would increase their compliance costs. We also note that, if being taxed under the FIF regime is perceived to be more favourable than being taxed on realised gains and losses (and dividends), including Australian listed shares in the FIF regime could create a bias towards investment in Australian shares (particularly as Australian shares are more substitutable for New Zealand shares than other countries' shares are).

74. This is not a central issue to taxing capital gains more comprehensively. As such, the Secretariat recommends that any change be decided following GTPP.

5. Foreign homes and rental properties held by New Zealand tax residents

75. New Zealand taxes based on both residence and source. New Zealand residents are generally taxed on their worldwide income, while non-residents are only taxed on New Zealand-sourced income. Under these general principles, gains derived by a New Zealand resident from the sale of property should be taxed in New Zealand, regardless of the source of that gain.

76. In Appendix B of the Interim Report, the Group considered whether there was a case for excluding gains derived by New Zealand residents on the sales of their foreign homes (at paragraph 21):

> … there is an argument for exempting homes owned outside New Zealand if it was likely that no New Zealand tax on the foreign home would be collected. This could be the case if the other country also taxed any capital gain on the property. If that same gain was taxable in New Zealand, a credit for that foreign tax would be allowed against the New Zealand tax payable. Any New Zealand tax on sale would accordingly be relatively small, such that the compliance costs might not be justified.
>
> An alternative to a full exclusion for foreign homes would be to apply a 'grey list' where only homes subject to tax in countries imposing similar capital gains taxes (and not receiving any main home exemption) would be excluded from the rules. In any event, any arguments for exclusion need to be balanced against perceptions of fairness if some overseas homes are out of the base. The Group is still considering this.

77. This Chapter considers:

    a. whether it is likely that (little or) no New Zealand tax on foreign homes would be collected;
    b. the possibility of a 'grey list'; and
    c. complexities with foreign mortgages and the financial arrangements rules.

5.1 Foreign homes/rental properties or foreign real property?

78. Although the quote above describes "foreign homes", some of the reasons outlined for exempting foreign homes (i.e. if New Zealand tax collected would be relatively small) may also apply to other foreign real property such as rental properties, farms or commercial land. The Secretariat notes that, in some cases, it could be hard to draw the line between a foreign home, which is rented out occasionally, and a rental property.

79. This Chapter will only discuss if there is a case for excluding foreign homes or foreign rental properties from the New Zealand tax base. It does not discuss excluding foreign real property more generally. If capital gains were subject to lower taxes in other countries than in New Zealand, exempting foreign real property could create a tax incentive for New Zealand residents to invest in foreign real property (rather than in New Zealand).

5.2 Is it likely that little or no New Zealand tax on foreign homes/rental properties would be collected?

80. All DTAs give the primary taxing right for gains over immovable or real property to the country in which the property is situated. As a result, New Zealand would only have a secondary or 'residual' taxing right over foreign homes/rental properties that are located in one of the 40 countries with which it has a DTA.[12] Even where there is no DTA, taxpayers can receive credits for foreign tax paid under New Zealand's domestic law.[13]

81. This means that, if a New Zealand resident taxpayer derived a gain from the sale of land in another country, and the other country taxed that gain, New Zealand would give the taxpayer a tax credit for the amount of foreign tax paid. If the amount of tax paid in the other country is equal to or greater than the amount of New Zealand tax on that gain, there would be no net New Zealand tax payable (net of foreign tax credits).

82. However, net New Zealand tax would still be payable if the tax on the gain in the other country was less than the New Zealand tax on the same gain. For example, the gain may be taxed at a lower rate than 33% as shown in Example 3, or a country may only tax part of a gain (e.g. Canada generally only taxes 50% of a capital gain). A preliminary analysis shows that countries that are likely to tax capital gains at rates below 33% include Australia,[14] Canada, France, Japan, Norway, South Africa, Spain, United Kingdom and the United States.

Example 3 – NZ resident, holiday home in Spain

Mahutu is a NZ tax resident with a holiday home in Spain that he purchased for €100,000. He sells it for €700,000 (a gain of €600,000).

Spain generally taxes non-residents at a fixed rate of 19%, which would make Mahutu liable for €114,000 (€600,000 * 19%) of Spanish tax.

Assuming Mahutu is at the 33% marginal tax rate, NZ tax on the holiday home would be €200,000 (€600,000 * 33%, ignoring foreign exchange). Mahutu would receive a foreign tax credit of around €114,000 to offset against his NZ tax liability, so the net NZ tax payable would be around €86,000.

83. Net New Zealand tax may also be payable if the country exempts the capital gain. For example, it may be an excluded home in that country, or exempted on death.

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[12] These countries are: Australia, Austria, Belgium, Canada, Chile, China, Czech Republic, Denmark, Fiji, Finland, France, Germany, Hong Kong, India, Indonesia, Ireland., Italy, Japan, Korea, Malaysia, Mexico, Netherlands, Norway, Papua New Guinea, Philippines, Poland, Russian Federation, Samoa, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, United Arab Emirates, United Kingdom, United States of America and Vietnam.

[13] Subpart LJ of the Income Tax Act 2007.

[14] Even though the 50% capital gains discount is not available to "foreign residents", it appears that a dual resident who is resident in New Zealand only under the DTA tiebreaker, would still qualify.

Example 4 – NZ resident dies with US rental properties

Chi and her niece Cassie are both NZ tax residents.

Chi owns five rental properties in the US. The cost base for each of these properties is US$50,000 each (total US$250,000). Chi dies and passes the rental properties to Cassie, who promptly sells them for US$200,000 each (total US$1m).

Assuming the US allows a basis step-up on death, Cassie's cost basis in the rental properties would be US$1m. The US ignores capital appreciation before death so the gains totalling US$750,000 would effectively go untaxed in the US.

Assuming a 33% tax rate and New Zealand allowing rollover on death (with no basis step-up), Cassie would assume Chi's cost basis in the properties of US$250,000. She would be taxed on a US$750,000 gain on the sale, resulting in US$250,000 worth of NZ tax (ignoring foreign exchange).

The NZ–US DTA would not limit New Zealand's taxing rights as there is no double tax.

84. Given the variety of ways in which different countries tax capital gains, and the fact that many countries tax capital gains at discounted rates, it is difficult to state with any confidence that including foreign homes/rental properties owned by New Zealand residents in the tax base would result in little or no New Zealand tax being collected.

85. We also note that it may be difficult to enforce compliance for gains derived on sales of foreign homes/rental properties. However, the Secretariat does not consider that this in itself is a good reason to exclude foreign homes/rental properties from the tax base.

5.3 Alternative 'grey list' approach

86. A 'grey list' is an alternative to full exclusion. The idea is that, if a New Zealand resident derives a gain (or loss) from selling a foreign home/rental property located in a grey list country, the gain (or loss) would be exempt from New Zealand tax altogether. A country could be included on the grey list if, after a survey of the country's laws and the relevant DTA, it was found that there would be little or no net New Zealand tax from taxing the sale of a home/rental property in that country.

87. Inland Revenue's past experience is that it is very difficult to keep grey lists up-to-date, as countries hardly ever notify New Zealand of changes to its tax laws (even though there is provision for doing so under most DTAs).

88. Even with Australia, there are a number of features of its tax laws (and not necessarily its capital gains tax laws) that, if changed, would affect how much net New Zealand tax could be collected. For example:

   a. Australia normally applies a 50% discount to calculating a taxable capital gain, if the asset sold had been owned for at least 12 months. This discount was removed for "foreign resident" individuals for capital gains made after 8 May 2012.[15]

b. However, the 50% discount still appears to be available to a taxpayer who is dual resident in Australia and New Zealand (e.g. if they have a house in each country) but treated as being only resident in New Zealand under the 'tiebreaker' provision in the NZ–Australia DTA. Under current law, such a person would be non-resident in Australia for purposes of the *NZ–Australia DTA*, but would remain tax resident in Australia for purposes of Australia's *domestic law*.

c. Australia is currently considering whether to align their domestic tax residence rules with residence under their DTAs.[16] If Australia decides to do so, this could effectively remove the 50% discount for many New Zealand residents with Australian homes/rental properties. This change was suggested in the context of a review of individual tax residency rules, and not the capital gains rules, which highlights why it is so difficult to ensure grey lists are kept up-to-date.

89. If the Group decides a grey list is appropriate, the Secretariat suggests that it should be limited to countries where New Zealand is likely to monitor changes in their tax laws.

90. We also note that grey lists can also cause issues with non-discrimination clauses in free trade agreements.

5.4 Complexities with foreign mortgages and the financial arrangements rules

91. Another reason why foreign homes/rental properties may be excluded is because of the complexities that arise with foreign mortgages under the financial arrangements (*FA*) rules.

92. A mortgage denominated in a foreign currency is a FA. Under the FA rules, income and expenditure (including foreign exchange gains and losses) is generally spread over the term of the arrangement on an accrual basis. Taxpayers who exit a FA (e.g. by fully repaying their mortgage) need to perform a 'wash-up' known as a base price adjustment (*BPA*) to ensure the correct amount of tax has been paid.

93. The FA rules include simplified rules for cash basis persons who fall under certain thresholds, on the basis that these persons have relatively small FA investments and pose little fiscal risk. Cash basis persons do not apply an accruals spreading method to their FAs. Instead, they only account for cash inflows and cash outflows and perform a BPA on exit.

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15 Income Tax Assessment Act 1997 (Cth) (ITAA 1997), s 115-105. A "foreign resident" is defined in s 995-1 as a person who is not a resident of Australia for the purposes of the Income Tax Assessment Act 1936 (Cth).

16 Board of Taxation *Review of the Income Tax Residency Rules for Individuals: Consultation Guide* (September 2018) at 16.

94. Currently, the FA rules cause issues with foreign mortgages as foreign exchange (*FX*) fluctuations can cause asymmetrical tax treatment (either in theory or in practice) with both foreign homes and foreign rental properties. Compliance cost issues can also arise. These issues are described below. Changes to the FA rules, including changes which would address some of these issues, are currently on the Tax Policy Work Programme and intended to be included in a future issues paper.

Foreign homes and foreign mortgages

95. Under the current law, there are two asymmetries with foreign mortgages secured against foreign homes:

    a. (some) FX movements affecting the values of foreign mortgages are taxable, while FX movements affecting the values of foreign homes are not taxable. This can result in a taxpayer being subject to tax on a FX gain or loss even when the NZ dollar value of their net investment is unchanged; and

    b. FX gains for foreign mortgages are (theoretically) taxable but some FX losses may not be deductible because of the general permission or private limitation. We note that in practice, general non-compliance results in few FX gains on foreign homes actually being taxed.

96. Officials' current thinking under the existing treatment of capital gains is to remove the theoretical asymmetry for foreign homes by treating private borrowings as excepted financial arrangements (EFAs), even if they are denominated in a foreign currency. This would make sense under the current law where the capital gain on the foreign home is not taxed in New Zealand, and would, for private borrowings, remove both asymmetries listed at paragraph 95 above.

97. If the capital gain on the foreign home is taxed in New Zealand, the first asymmetry listed above would automatically be removed (i.e. the private borrowings would not need to become an EFA). This is shown in Example 5 below. Law changes would still be required to remove the second asymmetry (by overriding the private limitation) and to ease compliance issues (discussed below).

Example 5 – Foreign home with mortgage

Sione is tax resident in New Zealand only under the NZ–Australia DTA. Assume the following facts on the last day of each income year. For simplicity, principal repayments, interest expenses and foreign tax credits are ignored:

- Y0 – Sione buys a house in Australia for AU$500,000, financed by a mortgage of AU$400,000. The AUD to NZD exchange rate is 1 to 1.
- Y1 – Sione's mortgage is still AU$400,000, but the AUD to NZD exchange rate is now 1 to 1.10.
- Y2 – Sione sells his house for AU$550,000 and uses the funds to pay off his AU$400,000 mortgage in full. The AUD to NZD exchange rate is now 1 to 1.15.

Overall, in NZD terms, Sione's net economic gain is **NZ$72,500** (being a NZ$132,500 gain on the property [AU$550,000*1.15 – AU$500,000*1.00] less NZ$60,000 of FX losses on the mortgage [AU$400,000*(1.15-1.00)]).

The NZ tax treatment under several options is as follows.

Current position (FX losses non-deductible, capital gain not taxable)

There would be no NZ tax consequences for Sione as his FX losses of $60,000 will not be deductible, but his capital gain of $132,500 would not be taxable, either.

Note, however, that if the AUD to NZD exchange rates were reversed so that Sione overall had FX gains of NZ$60,000, the law would require Sione to treat the gain as taxable unless the law was amended to make the foreign mortgage an EFA.

If capital gain is taxed

If Sione's capital gain is taxed, he will have a taxable gain of NZ$132,500 in Y2. He will also be able to claim FX losses of NZ$60,000 (all in Y2 if Sione is a cash basis person, or NZ$40,000 in Y1 and NZ$20,000 in Y2 if Sione is not a cash basis person and applies the mark-to-market spreading method).

Overall, Sione's net taxable income would be **NZ$72,500**, which matches his net economic gain.

Exclude capital gain and FX movements from base

If both the gain and FX movements are excluded from the tax base, there will be no New Zealand tax consequences for Sione.

Foreign rental properties and foreign mortgages

98. Under current law, the first asymmetry described in paragraph 95 above arises as capital gains on the rental property are not taxed (i.e. FX movements affecting the values of foreign mortgages are taxable, while FX movements affecting the values of foreign homes are not).

99. The second asymmetry described does not arise as FX gains on foreign mortgages financing a rental property are taxable and FX losses are deductible. However, an integrity risk arises as taxpayers are more likely to claim FX losses than they are to declare FX gains (i.e. compliance tends to be asymmetrical).

100. There are also compliance cost concerns as the thresholds for qualifying as a "cash basis person" have not increased since 1999.[17] With current house prices, many taxpayers can exceed those thresholds even if they only hold one house. Officials' current thinking is to include the following proposals in a future issues paper:

[17] Currently a cash basis person is a person who, for all FAs to which the person is a party: (a) the absolute value of accrual income and expenditure in the income year is $100,000 or less; (b) the absolute value on every day in the income year of all FAs added together is $1,000,000 or less; and (c) the deferral amount (difference between accrual income/expenditure and cash income/expenditure) for the income year is $40,000 or less.

a. increase all of the thresholds by 50%,[18] broadly matching the rise in Consumer Price Index since 1999; and
b. allow taxpayers with one foreign rental financed by a foreign mortgage to use the cash basis for returning FX gains and losses on the foreign mortgage (irrespective of the thresholds). If private borrowings to finance a foreign home are not made EFAs, this concession could also apply to foreign homes.

101. These measures would simplify compliance for most taxpayers, and remove the second asymmetry as a BPA requires FX gains and losses to be returned at the same time. If capital gains on foreign rental properties are taxed, this would also remove the first asymmetry. This is shown in Example 6.

Example 6 – Foreign rental property with mortgage

Assume the same facts as in Example 5 above, but instead of a foreign home, Sione has a single foreign rental property. For simplicity, principal repayments, interest and foreign tax credits are ignored.

Overall, in NZD terms, Sione's net economic gain is still NZ$72,500.

The NZ tax treatment under several possible options is set out as follows.

Current position (non-cash basis, capital gain not taxable)

Assuming Sione is not a cash basis person and applies the mark-to-market method for spreading his FA income, he will have the following taxable income in each year:

- Y1: Taxable FX loss of NZ$40,000 (being $400,000 * (1.10 – 1));
- Y2: Taxable FX loss of NZ$20,000 (being $400,000 * (1.15 – 1.10)).

Overall, Sione has made a net economic gain but has taxable losses of **NZ$60,000** as the capital gain on the rental property is not subject to tax in NZ.

If capital gain is taxed and cash basis is allowed

If Sione is allowed to use the cash basis for his rental property, he will have no NZ tax consequences in Y1. Instead, he will account for FX movements on a net basis on realisation.

In Y2, Sione will be taxed on a capital gain of NZ$132,500, and will have a taxable FX loss of NZ$60,000 (being AU$400,000 * (1.15 – 1.00)).

Overall, Sione's net taxable income is **NZ$72,500**, which is consistent with his net economic gain.

Exclude capital gain and FX movements from base

If both the gain and FX movements are excluded from the tax base, there will be no New Zealand tax consequences for Sione.

102. As shown above, some of the FA issues that currently arise can be resolved by taxing capital gains on foreign rental properties and extending the cash basis

[18] The new thresholds, corresponding with those described in footnote 17, would be (a) $150,000; (b) $1,500,000; and (c) $60,000, respectively.

person concession, or by excluding the capital gains and FX movements altogether.

5.5 Secretariat recommendation

103. There does not appear to be a case for exempting foreign homes and rental properties solely on the grounds that little tax would be raised by including them in the tax base.

104. However, the Secretariat notes that if gains on foreign homes and rental properties are taxed, a foreign mortgage secured against that property should also remain taxed under the financial arrangement rules. The compliance costs involved may be for a relatively small amount of tax.

105. On the other hand, we are conscious that exempting foreign homes and rental properties if capital gains on New Zealand baches and rentals are taxed is likely to create perceptions of unfairness.

106. The Secretariat does not consider there is a clear case either way for including or excluding foreign homes and rental properties from the tax base. We therefore recommend that this issue be considered further under the GTPP process. In either case, the Secretariat recommends consistent treatment for foreign mortgages and capital gains on foreign homes and rental properties (i.e. either both are in the tax base or both are excluded).

Appendix A: Suggested text for Final Report

The following is suggested Final Report text based on the Secretariat's recommendations. Amended text will be provided if the Group come to different decisions. Decisions that we have asked the Group to consider, but which the Secretariat has not made a recommendation, have been put in square brackets [ ]. We have not yet suggested text for the taxation of FIFs or foreign real property as this depends heavily on the decisions to be made by the Group.

Migration

1. The Group has considered the tax consequences of taxable assets entering and leaving the New Zealand tax base when an asset owner becomes ('immigrates') and ceases to be ('emigrates') New Zealand tax resident.

2. As a preliminary point, we noted that under the current tax residence rules, it can be hard in some cases to determine exactly when tax residence ends or begins. The individual tax residence rules may therefore need to be amended, or applied in a modified form, for the purposes of the rules proposed in this Chapter.

Emigration

3. In the Interim Report, we observed that if there is no tax imposed when a person emigrates, migration could become a simple way to avoid a realisation-based tax on capital gains. The solution suggested was to deem assets to be sold for market value immediately before the asset owner migrates ('the deemed disposal rule').

4. However, when an asset owner emigrates, some of the assets they hold may not leave the New Zealand tax base. Under New Zealand's double tax agreements (*DTAs*), New Zealand retains taxing rights over New Zealand land and assets forming part of the business property of a New Zealand permanent establishment (*PE*). We also note that, as a practical matter, if the existing resident land withholding tax (*RLWT*) rules are expanded to include all New Zealand real property sold by a non-resident, New Zealand should be able to continue to collect tax on the sale of New Zealand land by non-residents.

5. The Group therefore recommends that the deemed disposal rule should not apply to New Zealand land or assets of a New Zealand PE. By narrowing the range of assets to which the deemed disposal rule would apply, the number of people who would be taxed on their capital gains when they leave New Zealand can be significantly reduced.

6. We do not consider it appropriate to make the deemed disposal generally optional, as is the case in Australia. The Australian Board of Taxation recently noted:[19]

[19] Australian Board of Taxation Review of the Income Tax Residency Rules for Individuals (August 2017) at [1.288].

> Since it is acknowledged that a negative cash-flow impact is associated with any 'deemed' disposal, a taxpayer may make the choice to defer any deemed gain or loss until ultimate disposal. Mechanically, this is achieved by deeming a non-TAP asset to constitute TAP and relying on the (now foreign resident) taxpayer to subsequently furnish their income tax return in Australia disclosing the disposal. The likelihood of this occurring was questioned during consultation, with the general view being that a revenue leakage is more likely than not to arise.

7. The Board suggested the rules may need to be reformed. Making the deemed disposal optional may therefore undermine the reasons for the deemed disposal rule.

8. We are, however, conscious that a deemed disposal may cause compliance cost and cash flow issues for temporary emigrants, taxpayers holding illiquid assets, and taxpayers with modest unrealised gains. In our view, these concerns could be addressed with more targeted measures that still adequately protect New Zealand's tax base, such as an ability to [unwind the tax,] defer payment of tax and a *de minimis* threshold.

9. [Where a taxpayer emigrates for a short period but becomes tax resident again, the assets they hold would leave and re-enter New Zealand's tax base. A deemed disposal on emigration would therefore be an unnecessary compliance burden for the taxpayer. The Group suggests that, consistent with the approach in Canada, a taxpayer should be allowed to "unwind" a deemed disposal on emigration if they subsequently return to New Zealand holding the same assets in the same capacity. As this concession is aimed at temporary emigrants, we recommend that this option should not be available if the deemed disposal took place more than [10] years ago.]

10. Where a taxpayer emigrates holding certain illiquid assets (for example, an unlisted business with assets not attributable to a New Zealand PE), a deemed disposal could cause cash flow and valuation difficulties. In such cases, the Group considers the deemed disposal should still apply on migration, to crystallise New Zealand's taxing rights. However, we recommend that taxpayers be allowed to defer payment of the tax for a period. Conditions of deferral will be required to ensure New Zealand's tax base is protected, but the conditions should also be workable for taxpayers. We recommend that these conditions be decided following consultation with taxpayers.

11. With a *de minimis* threshold, a deemed disposal that results in capital gains that, in aggregate, fall below a certain threshold can be ignored. As people can become non-resident and resident again multiple times in their lives, the *de minimis* should be set at a modest level so that it is unlikely to be used to avoid tax on capital gains. We recommend a threshold of $15,000 of capital gains.

Immigration

12. If a person immigrates to New Zealand holding a taxable asset that they acquired while non-resident, the asset may enter the New Zealand tax base at the time the

person becomes tax resident in New Zealand. This does not apply to New Zealand real property and assets of a New Zealand PE, which are always in the New Zealand tax base.

13. The Group considers that when a person migrates to New Zealand, they should be treated as if they disposed of, and re-acquired their assets for market value at the time they become New Zealand tax resident.

14. This approach would ensure that any capital gain (or loss) accruing when the person was non-resident is not taxed in New Zealand, and is consistent with New Zealand's existing DTAs.

Taxation of FIFs

15. [To add after Group has made its decisions.]

Foreign homes and foreign rental properties

16. **[**To add after Group has made its decisions.**]**

Appendix B: Summary of interim decisions made by Group

1. In the Group's Interim Report, and as summarised in the *Agreed Design Features*[20] paper (as amended following the meeting), the Group made the following interim decisions on international issues.

Taxation of non-residents

2. Non-residents would only be taxed on realisations of:

    a. interests in land located in New Zealand (defined broadly);

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

    c. assets of a New Zealand branch or permanent establishment.

Taxation of shares in foreign companies

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

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

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

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

7. The FDR rules would be retained for taxing interests in FIFs.

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

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

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

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[20] *Agreed Design Features* Paper for Session 18 of the Tax Working Group (14 September 2018).

Migration

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

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

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

Appendix C: Comparative analysis – Emigration

Australia

1. When a resident taxpayer becomes non-resident, it is treated as a CGT event and the taxpayer is essentially deemed to dispose of any non-land/PE assets they hold at the time their tax residence ceases.[21]

2. Individuals (not companies or trusts) can elect to defer the deemed gain/loss on their non-land/PE assets until ultimate disposal:[22]

    a. **all** non-land/PE assets held by the taxpayer will be deemed to be taxable Australian property ("TAP") until another CGT event happens to the asset or the taxpayer becomes Australian resident again;

    b. if a subsequent CGT event happens to a deemed-TAP asset:
        i. while the taxpayer is non-resident, he/she will have to file a tax return and return any gain/loss. The gain may not be eligible for the 50% CGT discount (in whole or in part);[23] or
        ii. after the taxpayer has become resident in Australia again, they are effectively treated as having acquired as asset for its original cost on its original acquisition date (i.e. this overrides the ordinary rule that deems an immigrating taxpayer to have acquired their property for market value on the day they become tax resident).

3. Two significant problems with this concession are:

    a. If the taxpayer disposes of deemed-TAP assets while non-resident and does not file a return, the Australian Tax Office (ATO) has very little way of detecting or enforcing this.

    b. If the taxpayer becomes resident in a country with which Australia has a DTA, the DTA may prevent Australia from taxing capital gains on disposal of deemed-TAP assets. This is the case for Australia's US and UK treaties.

Board of Taxation notes

4. The Board of Taxation recently noted the problems outlined above in the course of reviewing the Australian tax residence rules (this was an ancillary issue in their review).[24] The Board noted the "general view" was that it was "more likely than not" there was revenue leakage from taxpayers not disclosing a sale of their deemed-TAP assets after they had left Australia.

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[21] Income Tax Assessment Act 1997 (Cth), s 104-160.

[22] Section 104-165.

[23] Section 115-105 and 115-115.

[24] Australian Board of Taxation Review of the Income Tax Residency Rules for Individuals (August 2017).

5. The Board suggested the rules might be improved by:

    a. including "deemed-TAP assets" in the foreign resident CGT withholding rules;[25]

    b. implementing an objective threshold (e.g. 6 years from deferral) after which the taxpayer will be deemed to have disposed of their "deemed-TAP assets", unless they have become tax resident in Australia again; and/or

    c. upon ceasing tax residence, any "deemed-TAP assets" should be catalogued and reported to the ATO, who can use this as a reference point to track future disposal of the assets. This could be incorporated as part of the annual tax return process. Canada has this.

Canada[26]

6. Taxpayers are deemed to have disposed of all property, other than land, business assets of a PE, certain pension/retirement plans, at fair market value immediately before they cease tax residence.[27]

7. If the fair market value of all property owned by the taxpayer on emigration is more than $25,000, they have to attach a list of all their property inside and outside Canada (except for any personal use property valued at less than $10,000) and attach it to their return.

8. Canada allows the following concessions:

    a. Election to defer: Taxpayers may also elect to defer payment of tax relating to the deemed disposition until they dispose of the property (without interest). Where the amount of federal tax deferred is more $16,500, the taxpayer has to provide adequate security to cover the amount (e.g. a letter of credit).

    b. Temporary emigrants: Taxpayers may elect to unwind a deemed disposition if they still own some or all of the property at the time they re-establish tax residence in Canada.

    c. Temporary residents: For taxpayers who were resident in Canada for less than a total of 5 years in the 10 years before emigration, there is no deemed disposition of property they already owned when they last became a resident or of property they inherited after they last became a resident.

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[25] Australia applies a 12.5% foreign CGT withholding rules tax on real property where the contract price is over $750,000.

[26] https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/individuals-leaving-entering-canada-non-residents/dispositions-property.html

[27] Income Tax Act (RSC 1985, c 1 (5th Supp)), s 128.1(4)(b).

United Kingdom

9. There are no general exit taxes on individuals. Historically (pre-1998), there was widespread avoidance as people would go to another country for as little as a year to avoid a significant tax impost.

10. The United Kingdom's rules are now very targeted to the more blatant cases of avoidance. Temporary non-resident individuals (taxpayers who go abroad for less than 5 years) are taxed on their return to the United Kingdom on any disposals made during their period of non-residence. This rule overrides treaties.[28]

United States

11. The United States has less need for exit taxes as it taxes citizens regardless of their residence. For individuals giving up their citizenship, and certain long-term permanent residents ceasing to be tax resident, their property is deemed to be sold at its fair market value on the day before the expatriation date.[29]

12. However, this deemed sale only applies if:

    a. the average net income tax of the expatriate for the previous 5 years is at least $155,000;[30] or
    b. the net worth of the expatriate is at least $2 million; or
    c. the expatriate failed to comply with US federal tax obligations for the last 5 years.

13. The first $600,000[31] of net gain is excluded from the amount realised on the deemed sale. If the expatriate later realises a gain or loss on the disposition or sale of the property, the amount realised will be adjusted according to the "mark to market" regime but the expatriate cannot use the $600,000 exclusion amount.

South Africa

14. An emigrating taxpayer (individual, company or trust) is deemed to dispose of their non-land/PE assets at market value *immediately before* their tax residence ceases.[32] "Immediately before" is significant as, before the legislation was amended, a Court held that South Africa lost taxing rights under a DTA once the corporate taxpayer's place of effective management had moved from South Africa to Luxembourg.[33]

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[28] Taxation of Chargeable Gains Act 1992 (TCGA), ss 10A and 10AA(4).

[29] Internal Revenue Code, s 877A.

[30] This amount is adjusted for inflation.

[31] $600,000 is the amount set in 2008. It is adjusted for inflation and was $663,000 in 2013.

[32] Income Tax Act 58 of 1962, s 9H.

[33] Commissioner for the South African Revenue Services v Tradehold Ltd [2012] ZASCA 61.

15. South Africa does not appear to have any concessions. However, ceasing tax residence in South Africa is generally a lot more difficult than it is in NZ and requires a person to notify the South African Revenue Service (SARS) that their tax residence has ceased.

16. South Africa has a withholding tax mechanism for land sold by non-residents.[34]

[34] Income Tax Act 58 of 1962, s 35A.

Appendix D: Comparative Analysis – Immigration

Australia

1. When a person becomes an Australian resident (other than a temporary resident), they are deemed to have acquired certain assets at the time they became resident for their market value at that time. This determines the cost base of the assets for Australian capital gains tax purposes.[35] There is no "median rule" or equivalent.

2. However, this does not apply to assets acquired prior to 20 September 1985 and assets that were "taxable Australian property" (TAP) (e.g. land in Australia, a more than 10% interest in a company where 50% of the company's assets are land in Australia, and assets that have been used in carrying on a business through a permanent establishment in Australia). Assets that were taxable Australian property continue to have their original cost base. There are also special rules for controlled foreign companies, certain employee share scheme interests.

Canada

3. Where a person becomes a Canadian resident they are deemed to have sold their property and immediately reacquired it for a cost equal to its fair market value on the date the person became resident in Canada.[36] This will be the cost base for determining the capital gain or loss when the property is subsequently disposed of. There is no "median rule" or equivalent.

4. This does not apply to taxable Canadian properties (e.g. land and assets that have been used in carrying on a business through a permanent establishment in Canada). The cost base for these assets will be their actual cost.

South Africa

5. Where a person becomes a resident of South Africa, the cost base of their assets for capital gains tax purposes is the market value of the assets the day before they became resident.[37] A "median" type rule applies to smooth out the gains or losses arising from the valuation.[38] (We note that South Africa generally does not seem to have basis 'step-up' clauses in their tax treaties, so the median rule is not overridden by a treaty step-up clause.)

6. This does not apply to immovable South African property (ie, land), or assets effectively connected with a permanent establishment in South Africa. The cost base of these assets will be their actual cost.

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35 Income Tax Assessment Act 1997 (Cth), subdivision 855-B.

36 Government of Canada website, https://www.canada.ca/en/revenue-agency/services/tax/international-non-residents/individuals-leaving-entering-canada-non-residents/newcomers-canada-immigrants.html#PBC (accessed 23 October 2018).

37 Income Tax Act 1994, Eighth Schedule, paragraph 24.

38 Comprehensive Guide to Capital Gains Tax, Issue 6, South African Revenue Services, at 234-236.

United Kingdom

7. A deduction is allowed for the cost of acquiring the asset.[39] There is no allowance for a person to elect to treat a deemed disposal at market value where they become resident in the United Kingdom. A person may therefore be required to pay capital gains tax on the whole of the gain made on an asset, even if that gain arose when they were not resident in the United Kingdom. In practice, some tax advisors advise people to trigger a disposal of appreciated assets before they become tax resident in the United Kingdom to achieve a step-up in cost basis.

8. Broadly, a person who is not resident for a tax year, will not be subject to capital gains tax.[40] However, the individual may be liable for non-resident CGT in respect of the disposal of residential property, or otherwise caught by the temporary non-resident rules when they resume UK tax residence. In addition, United Kingdom residents who have their permanent home ("domicile") outside the United Kingdom may not have to pay tax on non-UK capital gains.[41]

United States

9. The basis of a property is generally its cost, and there is no provision to adjust the basis if the asset was acquired before the person became tax resident in the United States.[42]

10. As in the United Kingdom, tax advisors generally advise people to trigger a disposal of appreciated assets before they become tax resident to achieve a step-up in cost basis.

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[39] Section 38, Taxation of Chargeable Gains Act 1992 (United Kingdom).

[40] Section 9, Taxation of Chargeable Gains Act 1992 (United Kingdom).

[41] HMRC website, https://www.gov.uk/government/publications/residence-domicile-and-remittance-basis-rules-uk-tax-liability/guidance-note-for-residence-domicile-and-the-remittance-basis-rdr1#how-does-domicile-affect-your-uk-income-tax-and-capital-gains-tax-liability.

[42] IRS website, https://www.irs.gov/publications/p551.

Appendix E: Other options for establishing cost base of taxable assets on immigration

1. This Appendix discusses other options for establishing cost base of assets that enter the New Zealand tax base on immigration:

    a. Original cost;
    b. Median rule; and
    c. Straight-line apportionment.

2. The discussion below uses examples of taxpayers immigrating from Australia and the United Kingdom. These two countries have been chosen because many of New Zealand's migrants come from these countries, yet they apply different approaches to taxes on emigration:

    a. Australia treats taxable assets as having been sold for market value on emigration (except where the taxpayer elects to treat the property as deemed-TAP property, as described above). If, say, a person migrates from Australia to New Zealand and is taxed in Australia on their assets on emigration, the NZ–Australia DTA allows that person to elect to be treated for New Zealand tax as if they had disposed of and reacquired their assets for market value immediately before they cease to be tax resident in Australia. The converse is true if a New Zealand resident migrates to Australia.

    b. The United Kingdom does not deem a disposal on emigration. Instead, it has a limited anti-avoidance rule for people who dispose of assets while temporarily non-resident (if the period of non-residence is less than 5 calendar years).

    Details of these countries' rules on emigration are set out in Appendix C. For simplicity, New Zealand's transitional residence rules are ignored in the examples.

Option 1: Original cost

3. The first option is to set the cost base of taxable assets entering New Zealand at their original cost. In theory, this would allow New Zealand to tax the entire gain or loss on disposal, including any gain that accrued before the person became a New Zealand resident. The United Kingdom and the United States both use this approach for immigrants.

4. If the country from which the taxpayer came (the 'other country', for short) taxed the gain that accrued while the taxpayer was in that other country (by taxing a deemed disposal on emigration), New Zealand may be required to allow the foreign tax credit under the relevant DTA. This is the case under the NZ–Australia DTA.

Example 7 – Migration from Australia, original cost

In Year 1, Tom, an Australian tax resident, buys some Australian shares for $100.

In Year 3, Tom migrates to New Zealand. Tom ceases to be resident in Australia on the same day he becomes resident in New Zealand (‘Migration Day’). The value of his shares is $150.

In Year 10, Tom sells the shares for their market value of $210. His actual capital gain is therefore **$110**.

The tax consequences for Tom will be:

- In Year 3, Tom is treated for Australian tax purposes as having a capital gain of **$50**.
- In Year 10, Tom will be treated for New Zealand domestic tax purposes as having derived a capital gain of $110. However, this is modified by the NZ–Australia DTA, which allows Tom a cost base of $150, which effectively reduces (by way of a tax credit) the gain that is taxable in New Zealand to **$60** (being $210 - $150).

Overall, Tom has been taxed on his actual capital gain of $110 ($50 of which was taxed in Australia and $60 of which was taxed in New Zealand).

5. Setting the cost base of assets at their original cost has the advantage that, if the other country did ***not*** tax a deemed disposal on emigration, the entire gain or loss will still be taxed (in New Zealand only). This is the case with United Kingdom.

Example 8 – Migration from the UK, original cost

Assume the same facts as in Example 7, except that Tom migrated to New Zealand from the UK instead of Australia.

The tax consequences for Tom will be:

- There are no UK tax consequences as the UK does not generally tax assets on emigration.
- In Year 10, Tom will be treated as having derived a taxable capital gain in New Zealand of **$110** (being $210 - $100). The NZ–UK DTA does not affect this.

6. The main difficulty with using original cost as the cost base is that original cost can be easily manipulated by transfers between associated persons. It appears that some tax advisors in the United States and United Kingdom advise immigrants with substantial assets to trigger a realisation before they become tax resident. (Such a realisation may be structured so that it is not taxable, as countries often allow some rollover for transfers between associated persons.)

7. Although New Zealand has associated persons rules that could ordinarily deem such transfers to take place at market value, enforcing these rules for transactions taking place outside of New Zealand would pose practical difficulties.

Example 9 – Migration from the UK, with transfer to associated person

Assume the same facts as in Example 8, except that Tom migrates to New Zealand with his wife Theresa, and, just before they migrate, Tom sells his shares to Theresa for $240 (market value of $150). Theresa ultimately sells the shares in Year 10 for their market value of $210.

The tax consequences for Theresa will be:

- There are no UK tax consequences as transfers between spouses are disregarded. Theresa would assume Tom's cost base in the shares of $100, but as with Tom in Example 2, she will not be taxed in the UK on emigration.
- In Year 10:
  - If New Zealand simply took actual cost as the cost base, Theresa will be treated as having a taxable capital loss in New Zealand of **-$30** (being $210 - $240).
  - If New Zealand applied the same cost base that Theresa had in the United Kingdom ($100), she will be treated as having a taxable capital gain in New Zealand of **$110** (being $210 - $100). However, it could be hard for New Zealand to find out what this would be.
  - If New Zealand applied our associated persons rules so that Tom is treated as having sold his shares to Theresa for market value of $150, Theresa will be treated as having a taxable capital gain in New Zealand of **$60** (being $210 - $150). However, this could be hard to apply in practice.

8. We also note that, if original cost is the option used, it will be overridden by the median rule that applies on the Valuation Day for assets that the immigrant acquired before Valuation Day. As such, in at least the first few years after Valuation Day, the cost base of most assets entering the tax base on immigration will likely be their market value on Valuation Day.

Option 2: Median rule

9. The median rule takes the cost base of an asset as being the median of:

   a. the **actual cost**, including costs incurred both before and after the taxpayer became tax resident;
   b. the **market value** on the day the taxpayer become tax resident, plus costs incurred after the taxpayer become resident; and
   c. the **sale price**.

   In the *Valuation Day* paper, the Secretariat recommended that the median rule apply to all assets except for listed shares on Valuation Day.[43]

10. The reason why the median rule was recommended for transition on Valuation Day was to protect taxpayers against 'paper gains' (where there is a gain when measured from Valuation Day, but the asset was sold at a loss overall) and protect the Government against 'paper losses' (where there is a loss when measured from

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[43] *Valuation Day* Position Paper for Session 20 of the Tax Working Group (12 October 2018).

Valuation Day, but the asset was sold at a gain overall). On migration, this issue should not arise if there is a deemed disposal in the emigrating country (e.g. Australia, Canada and South Africa).

11. The median rule might be workable for countries that do not tax a deemed disposal on emigration but limiting it in this way would add complexity. In addition, the ease with which cost can be manipulated by associated person transfers occurring outside New Zealand suggests that the median rule is just as vulnerable to inflated market valuations as a market value rule (option 2).

12. An alternative reason for the median rule is to protect the tax base against inflated valuations and/or market highs on the transition date. However, countries that tax a deemed disposal on emigration often negotiate 'step-up' clauses in their DTAs, allowing the taxpayer to elect to be treated as if they had, immediately before their migration, sold and reacquired their assets for market value. Such clauses can effectively override the median rule when it would benefit the taxpayer as shown in the examples below, resulting in a 'heads I win, tails you lose' situation for the taxpayer.

13. South Africa uses a median rule for assets that enter the tax base through immigration, and it appears they do not tend to agree to 'step-up' clauses in their DTAs. South Africa's DTAs with Australia, Canada and New Zealand do not have a 'step-up' clause, but New Zealand DTAs with Australia and Canada both have this clause.

14. If the taxpayer is coming from a country that taxes on emigration (e.g. Australia), the median rule may fail to protect the New Zealand tax base from a market high or inflated valuation if it is overridden by a DTA that allows a step-up from cost. This is shown in Examples 10 and 11.

Example 10 – Median rule: market value above cost, asset sold at gain

Assume the same facts as in Example 7, except with the following numbers:

- Original cost $100
- Market value on Migration Day is $270
- Sales price $210

Applying the median rule, the cost base will be $210, and the tax consequences for Tom are:

- In Year 3, Tom is treated for Australian tax purposes as having a capital gain of **$170**.
- In Year 10, Tom will be treated for New Zealand tax purposes as having no taxable capital gain or loss. However, the NZ–Australia DTA may allow Tom to elect to be treated for New Zealand tax purposes as if he had, immediately before ceasing to be Australian tax resident, sold and reacquired the shares at market value. New Zealand may be required to allow Tom a tax loss of **-$60** (being $210 – $270).

In this case, Tom is taxed on an overall gain of **$110** (being $170 in Australia and -$60 in New Zealand), which matches his economic gain. The median rule is overridden by the treaty and has no effect.

Example 11 – Median rule: market value above cost, asset sold at loss

Assume the same facts as in Example 7, except with the following numbers:

- Original cost $100
- Market value on Migration Day is $270
- Sales price $80

Applying the median rule, the cost base will be $100, and the tax consequences for Tom will be:

- In Year 3, Tom is treated for Australian tax purposes as having a capital gain of **$170**.
- In Year 10, Tom will be treated for New Zealand domestic tax purposes as having a capital loss of -$20. However, the NZ–Australia DTA may allow Tom to elect to be treated for New Zealand tax purposes as if he had, immediately before ceasing to be Australian tax resident, sold and reacquired the shares at market value. This could increase Tom's taxable loss in New Zealand to **-$190** (being $80 - $270).

In this case, Tom is taxed on an overall loss of **-$20** (being $170 in Australia and -$190 in New Zealand), which matches his economic loss. The median rule is overridden by the treaty and has no effect.

15. However, because 'step-up' clauses in DTAs are typically at the election of the taxpayer (as is the case with both Australia and Canada), the taxpayer would use this clause when it would result in a basis 'step-down' (i.e. lower than what they would get under New Zealand domestic law). In these cases, the median rule can cause New Zealand to forego tax revenue when the market value on Migration Day is below cost (e.g. during a market slump), whether or not the asset is ultimately sold for a gain or a loss. In this case the immigrant will be under-taxed, as shown in Examples 12 and 13.

Example 12 – Median rule: market value below cost, asset sold at gain

Assume the same facts as in Example 7, except with the following numbers:

- Original cost $100
- Market value on Migration Day is $70
- Sales price $120

Applying the median rule, the cost base will be $100, and the tax consequences for Tom will be:

- In Year 3, Tom is treated for Australian tax purposes as having a capital loss of **-$30**.
- In Year 10, Tom will be treated for New Zealand domestic tax purposes as having a capital gain of **$20**. (The NZ–Australia DTA would not apply, as there is no reason for Tom to elect to have a lower cost base of $70.)

In this case the median rule causes New Zealand to give up tax on $30 of Tom's $50 gain since becoming a New Zealand tax resident, causing Tom to be under-taxed overall.

Example 13 – Median rule: market value below cost, asset sold at loss
Assume the same facts as in Example 7, except with the following numbers: • Original cost \$100 • Market value on Migration Day is \$70 • Sales price \$80 Applying the median rule, the cost base will be \$80, and the tax consequences for Tom will be: • In Year 3, Tom is treated for Australian tax purposes as having a capital loss of **-\$30**. • In Year 10, Tom will be treated for New Zealand tax purposes as having no taxable capital gain or loss. (The NZ–Australia DTA would not apply, as there is no reason for Tom to elect to have a lower cost base of \$70.) In this case the median rule causes New Zealand to give up tax on \$10, causing Tom to be under-taxed overall.

16. The above examples are summarised as follows:

Effect of median rule	**Situation**			
	MV > Cost, Asset sold for gain	**MV > Cost, Asset sold for loss**	**MV < Cost, Asset sold for gain**	**MV < Cost, Asset sold for loss**
If DTA does not allow a step-up (e.g. UK)	Protects NZ tax base	Protects NZ tax base	Protects taxpayer	Protects taxpayer
If DTA allows a step-up (e.g. Australia)	No effect overridden by DTA (Example 10)	No effect, overridden by DTA (Example 11)	Under-taxes taxpayer (Example 12)	Under-taxes taxpayer (Example 13)

This table does not show situations where the market value is the median, as the result under the median rule would be no different to under the market value rule.

Option 3: Straight-line apportionment

17. A third option is to allow a taxpayer's overall gain to be apportioned based on the number of years the taxpayer held the asset while they were a New Zealand resident divided by the total number of year the taxpayer held the asset. We are not aware of any country that adopts this approach.

18. The straight-line apportionment method can result in taxpayers being under-taxed or over-taxed (relative to the actual gain that accrued while they were New Zealand resident). However, several issues with this method would tend towards under-taxation:

    a. This method uses the asset's original cost to work out the total gain that is to be apportioned. As discussed earlier, original cost can be manipulated by associated person transfers outside New Zealand.

b. It can be very hard to verify the length of time that taxpayer held an asset for in the other country.

c. Even if there is no manipulation, if a DTA allows a step-up to market value, the taxpayer is likely to choose this option only when it is to their advantage.

Example 14 – Migration from Australia, original cost

Assume the same facts as in Example 7 – i.e.:

- In Year 1, Tom buys his shares for $100.
- In Year 3, Tom migrates from Australia to New Zealand. The value of the shares is $150.
- In Year 10, Tom sells the shares for market value of $210, realising a capital gain of **$110**.

Tom was only tax resident in New Zealand for 7 out of the 10 years he held the shares. Under a straight-line apportionment approach, he would only be taxed on 70% of his $110 capital gain, being **$77**.

This is likely modified by the NZ–Australia DTA, which allows Tom to be treated as if he sold his shares for $150 and reacquired them at the same price on his migration. Accordingly, the gain that is taxable in New Zealand is reduced to **$60** (being $210 - $150).

Appendix F: Expected Return Method

1. This Appendix sets out the equivalence between a comprehensive income tax (CIT) and the RFRM, and contrasts that equivalence with what happens when, instead of a risk-free rate, an "expected rate of return" is used. To begin with, it repeats some material from section 2 of the RFRM paper.

2. To understand the basic idea, consider a simple example based on Annex A in the McLeod Review's final report. An investor has $200 which is split equally between risk-free and risky investments. The risk-free investment generates $104 a year later, which is returned to the investor (i.e. the risk-free return is 4%). The investor invests the rest in a risky investment which returns $130 half of the time, but only $90 the remaining half of the time. The risky investment generates a 10% expected return. This provides a 6% risk premium over and above the risk free return which compensates investors for taking on risk.

3. The following table sets out the potential outcomes for someone with a 33% tax rate assuming, initially, that we have a CIT with full deductions for any capital losses.

Table 1: Initial position with CIT

	Risk-free investment	Risky investment	Total before tax	Tax	Net return
Risky investment does well	$4.00	$30.00	$34.00	$11.22	$22.78
Risky investment does not do well	$4.00	-$10.00	-$6.00	-$1.98	-$4.02
Expected return (50% * each scenario above)	$4.00	$10.00	$14.00	$4.62	$9.38

4. The person in the table above has an expected (or average) return after tax of $9.38.

5. If the government introduces the RFRM, the opening value of the portfolio is taxed at the risk-free rate of 4%. If the person does not adjust the portfolio, the change in tax treatment will result in the following outcomes:

Table 2: RFRM with no portfolio adjustment

	Risk-free investment	Risky investment	Total before tax	Tax ($200 * 4% * 33%)	Net return
Risky investment does well	$4.00	$30.00	$34.00	$2.64	$31.36
Risky investment does not do well	$4.00	-$10.00	-$6.00	$2.64	-$8.64
Expected return (50% * each scenario above)	$4.00	$10.00	$14.00	$2.64	$11.36

6. The person's expected return has increased from $9.38 to $11.36. At the same time the risk of the person's portfolio has increased. The good outcome now provides $31.36 (instead of $22.78), and the bad outcome now provides a loss of $8.64 (instead of a loss of $4.02). Government tax revenue has shrunk from an expected $4.62 (with some market risk), to a definite $2.64 (without market risk).

7. If the investor wants to go back to the old risk exposure, she could sell $33 of her risky investment and put it into the risk-free investment so that she has $133 of risk-free investment and $67 of risky investment. If she did that, the result would be:

Table 3: RFRM with portfolio adjustment

	Risk-free investment	Risky investment	Total before tax	Tax ($200 * 4% * 33%)	Net return
Risky investment does well	$5.32	$20.10	$25.42	$2.64	$22.78
Risky investment does not do well	$5.32	-$6.70	-$1.38	$2.64	-$4.02
Expected return (50% * each scenario above)	$5.32	$6.70	$12.02	$2.64	$9.38

8. You can see that the final column of table 3 is identical to the final column of table 1. Through portfolio adjustments, the investor has identical post-tax returns under the RFRM as she did under the CIT. Government revenue is lower, but it is risk-free.

9. It might be thought that a major advantage of taxing income as comprehensively as possible rather than having an RFRM is that doing so is likely to generate more tax revenue. However, there is an important flipside. While there would be a higher expected revenue stream under a CIT, this revenue stream would be risky and there are costs in being exposed to risk. As Weisbach (2004) has pointed out, if the government wants to earn additional revenue but expose itself to risk, it can do this by choosing a CIT regime, or separately investing into risky markets, including the share market.

10. Thus, this is the basic logic behind the RFRM as a possible alternative to a CIT (or a tax which gets as close to a CIT as is practicable).

11. Now we look at what happens if instead of a "risk-free return", the expected return is used as the rate when there is an investment in the risky asset. It is assumed that the risk-free investment is taxed on its actual return. The expected return in the example is 10%.

Table 4: Expected Return Method (ERM) with portfolio adjustments

	Risk-free investment	Risky investment	Total before tax	Tax on risk-free asset	Tax on risky asset ($133 * 10% * 33%)	Total tax	Net return
Risky investment does well	$5.32	$20.10	$25.42	$1.76	$4.39	$6.15	$19.27
Risky investment does not do well	$5.32	-$6.70	-$1.38	$1.76	$4.39	$6.15	-$7.54
Expected return (50% * each scenario above)	$5.32	$6.70	$12.02	$1.76	$4.39	$6.15	$5.87

12. As can be seen in the table below, the expected return method reduces returns in all scenarios, and does not provide an equivalent outcome to the comprehensive income tax. It is over-taxation relative to the RFRM or the CIT.

Table 5: Comparison of CIT, RFRM, and ERM with portfolio adjustments

	CIT	RFRM	ERM
Risky investment does well	$22.78	$22.78	$19.27
Risky investment does not do well	-$4.02	-$4.02	-$7.54
Expected return (50% * each scenario above)	$9.38	$9.38	$5.87

13. Potential advantages of an RFRM that have been suggested include that there would be no lock in (although this depends critically on there being accurate valuations). A realisation-basis tax on capital gains can lock taxpayers into existing assets even when it would be more efficient for them to swap to new assets. A disadvantage of an RFRM is the perception that it does not provide horizontal equity in terms of investors paying the same level of tax on their income.