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NEW ZEALAND

THE COMPLIANCE COSTS OF TAXING CAPITAL GAINS

A REPORT PREPARED BY

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[*] In preparing this Report I have drawn on previous empirical work conducted and published alone and with a number of colleagues, including in particular Professors Binh Tran-Nam and Michael Walpole, and Dr Philip Lignier. I am very happy to acknowledge their contributions to the joint research and publications from which I have drawn material. All mistakes in this Report are my own.

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ABBREVIATIONS USED IN THIS REPORT

AEA	Annual Exempt Amount
AU$	Australian dollar
CGT	Capital gains tax
CIT	Corporate income tax
GDP	Gross domestic product
GST	Goods and Services Tax
ICAEW	The Institute of Chartered Accountants in England and Wales
OECD	The Organisation for Economic Cooperation and Development
NZ$	New Zealand dollar
PIT	Personal income tax
SME	Small and medium enterprise
TWG	Tax Working Group
UK	United Kingdom
US	United States of America
VAT	Value Added Tax

EXECUTIVE SUMMARY

This Report explores the tax compliance costs – those costs incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax – that New Zealand could expect to encounter if a capital gains tax (CGT) were introduced.

Empirical research indicates that tax compliance costs are significant and high for most taxes, that they are regressive –their burden falls disproportionately on those personal taxpayers on lower incomes and those business taxpayers with lower levels of profit – and that they are not reducing over time. Key drivers of compliance costs are change, complexity and choice. The nature of the tax, type of taxpayer, business structure, industry sector and size of business or level of income can also strongly influence the compliance costs profile.

Research into the tax compliance costs of CGT regimes broadly mirrors these findings, and also indicates that particular issues such as record-keeping and valuation are further important drivers of CGT compliance costs.

The compliance costs of CGT regimes are typically and anecdotally thought to be relatively high in comparison to the compliance costs imposed by other taxes. However, the empirical evidence qualifies this conclusion in two important ways. In the first place it notes that although some taxpayers face high CGT compliance costs, the CGT regime applies to a relatively few taxpayers compared to say, the goods and services tax (GST) or personal or corporate income taxes (PIT or CIT). As a result, overall CGT compliance costs are not high relative to the compliance costs of other taxes.

The second qualification is that the Australian CGT regime is often the source for concerns about high CGT compliance costs. However, a number of relatively unique structural features have caused Australian CGT compliance costs to be higher than would normally be expected of a CGT regime. These structural features include: the decision to "grandfather" all gains in relation to any assets acquired before 1985; a very generous effective tax rate for capital gains compared to revenue gains which encourages and incentivizes high-cost tax planning to convert highly taxed income to preferentially taxed capital gains; a far more extensive range of roll-overs and deferral regimes compared to most other countries leading to far more statutory and compliance complexity; and a very generous but complex and confused set of CGT small business concessions (involving both exemptions and roll-overs). These high-cost structural features have been compounded by excessive and frequent changes to the legislative provisions in the 33 years since the regime was introduced, with resulting uncertainty and unpredictability in their operation.

The Report examines the CGT design features proposed in the *Future of Tax: Interim Report* prepared by the Tax Working Group and published in September 2018 (the TWG Interim Report). It concludes that overall the design feature suggest that the CGT compliance costs would not be unduly onerous. Most design features reflect international best practice and take

the compliance burden into account wherever possible. A few will lead to higher compliance costs than might otherwise be the case. And for some it is impossible to evaluate the likely compliance cost impact.

The Report also examines three other measures or sets of measures that some argue would help to mitigate or minimize CGT compliance costs: the use of an annual exempt amount (AEA); the introduction of a special regime for the SME sector; and suggestions that can be adopted by the New Zealand Inland Revenue to shift part of the compliance burden, at least in the early years, from the shoulders of the taxpayers and their advisers to the better-resourced shoulders of the revenue authority.

It suggests that there is merit in the first and the third of these measures, or sets of measures, but that a concessional regime for small businesses should not be contemplated if its rationale is simply to mitigate or minimize tax compliance costs. Experience suggests that such small business concessional regimes rarely achieve their intended goals and often end up making the system more complex (and thereby exacerbating compliance costs). It accepts the OECD conclusion that, if compliance costs are the issue, it is far better to seek to simplify the overall tax system for all taxpayers rather than seek to simplify it just for some.

The Report concludes with a set of high-level principles (relating to change, complexity and choice) that may help to guide the design of a CGT regime that does not impose unduly excessive compliance burdens on taxpayers, and with 14 specific recommendations that will assist in compliance cost mitigation and minimization for the proposed CGT regime.

I. INTRODUCTION AND CONTEXT

1. Modern taxation systems have the capacity to impose a heavy burden on taxpayers. That burden typically consists of three elements. In the first place there are the taxes themselves, whether they are taxes on the income or profits, goods and services or wealth. Secondly, there are the efficiency costs (variously referred to as deadweight losses or excess burden), involving tax-induced market distortions. And finally, there are the *operating costs of the tax system*: the costs to the government (ultimately borne by taxpayers) of administering and collecting the taxes (usually referred to as *tax administration costs*), and the costs expended by taxpayers in complying with their tax obligations (usually referred to as *tax compliance costs*).[2]

2. This Report considers the tax compliance costs that may arise if some form of capital gains taxation (usually referred to as a CGT, a practice adopted in this Report) were to be introduced in New Zealand.[3] It provides an essential overview of research into tax compliance costs, establishes the critical causes and drivers of tax compliance costs and considers factors that may help to minimize or mitigate those costs in the context of the design features that have been proposed in the *Future of Tax: Interim Report* prepared by the Tax Working Group (the TWG Interim Report) which was published on 20 September 2018. Finally, it makes recommendations that will help to reduce tax compliance costs if a CGT were to be introduced in New Zealand.

3. It takes as its starting point the suggestions for a possible New Zealand CGT regime contained in Chapter 6 and Appendix B of the TWG Interim Report. It particularly addresses the following questions raised by the TWG Secretariat with the author of this Report in relation to CGT:

- what are the major causes of compliance costs in Australia?
- are there ways to avoid these costs by making sensible design decisions, including de minima/exemptions?
- is there any case for exemptions/rollovers/special de minima for small businesses in particular, from a compliance cost perspective?
- are the suggestions in Chapter 6 and Appendix B of the TWG's Interim report likely to help minimize compliance costs? What changes would you recommend with a mind to minimizing compliance costs?
- whether there are any tax authority administrative practices that have had a material impact (for better or worse) on compliance costs?

4. The TWG Interim Report identifies two possible options for taxing capital gains in New Zealand: "extending the taxation of realized capital gains from specific assets not already

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[2] C Evans (2008), "Taxation compliance and administrative costs: an overview", in *Tax Compliance Costs for Companies in an Enlarged European Community*, (edited Lang M, Obermair C, Schuch J, Staringer C and Weninger P), London: Kluwer Law International, pp 447-468.

[3] Tax administration costs are not explicitly considered in this Report, although where relevant they are mentioned. It can be expected that there will be a positive relationship between tax compliance costs and tax administration costs. Previous research (see Section III below) indicates that tax compliance costs are typically a multiple (between two and six) of tax administration costs.

taxed"; or "taxing certain capital assets on a deemed return basis, referred to [as] a risk-free return method".[4] The first represents the traditional means of taxing capital gains followed in some form or other by the large majority of OECD and non-OECD countries and is the principal focus of this Report. The alternative "risk-free return method" exists only in a very few other jurisdictions and is not considered in any detail in this Report given the complete absence of empirical or other firm indications of the likely compliance cost implications were such a method to be adopted in New Zealand.

5. Although there is relatively little empirical research available on the topic, CGT is generally regarded as being a form of taxation that leads to high tax compliance costs for those taxpayers affected. The TWG Interim Report suggests that the "extension of capital income taxation will significantly increase compliance and administration costs".[5] This sentiment is often borne out by anecdotal evidence from taxpayers and practitioners, although it should be noted that the significance of such costs needs to be "moderated" by reference to the numbers and types of taxpayers impacted by the tax: a tax which imposes high compliance costs on a small number of sophisticated taxpayers may have far less overall compliance cost impact than a tax with lower tax compliance costs that affects a larger number of unsophisticated taxpayers.

6. Nonetheless, it is almost universally accepted that a CGT is very hard to justify on the grounds of simplicity, and it is therefore inevitable that there will be tax compliance cost implications for those taxpayers affected by the tax. The critical purpose of this Report is to place these costs in an appropriate context and to suggest measures designed to ensure that they are not more onerous than needs to be the case. Sensible design can considerably mitigate the impact of CGT compliance costs.

7. The Report is structured as follows. Section II explains some key definitions and concepts relating to CGT and tax compliance costs. Section III then reviews the extant research to establish the major trends and outcomes of that research, together with the causes and drivers of tax compliance costs, initially in broad terms and subsequently with particular reference to the incidence of CGT compliance costs in countries such as the United Kingdom (UK) and Australia. Section IV then takes the proposed design features of a CGT regime for New Zealand detailed in the TWG Interim Report and considers the likely tax compliance cost implications of those design choices. Section V identifies other design choices that may help to minimize or mitigate such costs, including the possibility of an annual exempt amount (AEA), the consideration of special treatment for small businesses, and possible administrative practices that could be undertaken by the New Zealand Inland Revenue in order to assist in the minimization or mitigation of the burden of the CGT regime. Section VI concludes and provides a summary of the recommendations that emerge from this Report.

[4] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 35.

[5] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 34.

II. KEY DEFINITIONS AND CONCEPTS

Taxation of capital gains

8. Quite possibly no area of taxation illustrates better the challenges of tax system design than the taxation of capital gains. While persons working in any tax system of the world use the same term to describe this feature of their tax system, the actual words refer to the widest range of tax concepts imaginable. This lack of consensus as to the meaning of capital gains has been expressed in the following manner:

> *Though the term "capital gain" or its linguistic equivalent is frequently used ..., the precise contours of the concept vary considerably from country to country. In addition, the concept plays a different role in different systems.*[6]

9. As noted in the TWG Interim Report there are strong equity and efficiency grounds for taxing capital gains.[7] However, the case for taxing capital gains is not very strong on simplicity grounds, whether considered from the perspective of the taxpayer (who faces high compliance costs) or the revenue authority (faced with difficult administrative issues).[8] Indeed, the Australian Asprey Report was emphatic on the point:[9]

> *It is a tax which, in any administrable form, must be complex and difficult, and produce some anomalies and inequities of its own. There is no doubt whatever that any revenue it raises could be more cheaply and easily raised in other ways. By the criterion of simplicity it fails.*

10. This is, perhaps, a somewhat harsher judgement than subsequent experience with regimes for taxing capital gains would suggest. Although the legislation is complex and difficult, arguably it is no more complex or difficult than many other parts of the taxing statutes. Moreover, taxing capital gains (as well as all other forms of income) removes, at a stroke, one of the greatest areas of uncertainty that has bedevilled much of the debate in common law taxation jurisprudence over the last two centuries: the distinction between capital and income.[10] As long ago as 1966, the Canadian Carter Report had argued that the inclusion of capital gains in income would increase simplicity by eliminating arguments over whether a receipt was capital or income.[11] Many of the subjective, purposive tests that lead to costly tax litigation

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[6] HJ Ault and BJ Arnold (2010), *Comparative Income Tax: A Structural Analysis,* Den Haag: Kluwer Law International, at p 237.

[7] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at pp 31-34.

[8] See, for example, C Evans (2003), *Taxing Personal Capital Gains: Operating Cost Implications,* Sydney: Australian Tax Research Foundation.

[9] Taxation Review Committee (Justice KW Asprey, chair) (1975), *Full Report,* Canberra: Australian Government Publishing Service, 31 January 1975, at [23.9].

[10] C Evans and R Krever (2017), "Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand", *New Zealand Journal of Tax Law and Policy* Vol 23, No 4, pp 486-515, at p 493.

[11] Royal Commission on Taxation (Kenneth Carter, chair) (1966), *Royal Commission on Taxation Report,* Ottawa: Queen's Printer, at pp 335–336.

would be eliminated by the shift to a more easily identifiable and measurable tax base, so long as the tax treatment of income and capital were more or less identical (as the TWG Interim Report suggests it would be if New Zealand were to adopt a CGT). Sheppard cites other Canadian and United States (US) research advancing the case for full taxation of capital gains by reference to arguments of enhanced simplicity and certainty.[12] The Australian Review of Business Taxation suggested many simplicity benefits could be realized simply by defining the boundaries of any capital gains concession in the legislature in place of the convoluted and confusing array of imprecise tests that mark the non-statutory judicial doctrine boundary between ordinary income and capital gains.[13]

11. Nonetheless, taxing capital gains is not straightforward and inevitably leads to increased tax compliance costs. The present Report now considers conceptual issues relating to these tax compliance costs in more detail.

Tax compliance costs

12. Although there is some debate in the literature about the precise meaning of tax compliance costs, most authors are happy to adopt the classic definition provided by Sandford et al in 1989: those costs "incurred by taxpayers, or third parties such as businesses, in meeting the requirements laid upon them in complying with a given structure and level of tax".[14] In this sense tax compliance costs cover the whole range of costs from initial record keeping through to the submission of any required forms or returns, remittance of tax and on to any audit and/or post-audit activity that a taxpayer or advisers may encounter.

13. Most researchers also adhere to the convention that breaks down tax compliance costs into three broad components of cost incurred by taxpayers that relate to the costs of complying with their tax obligations:

- *explicit* costs represented by monetary outgoings paid to external parties, such as tax agents and tax advisers or to internal employees in relation to tax affairs;
- *implicit* costs represented by the time spent by taxpayers and unpaid helpers in dealing with their tax affairs; and
- non-labour costs (also referred to as *incidental* costs) corresponding to personal or business overhead costs such as equipment, computers, stationery, travel etc that arise as a result of tax compliance.[15]

14. Beside these measurable costs, taxpayers may also experience psychological costs in the form of stress, anxiety and frustration arising from compliance with their obligations and

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[12] A Sheppard (1988), "Capital Gains: Twenty Years Later A Buck Is Still Not A Buck" in Neil Brooks (ed) *The Quest for Tax Reform: The Royal Commission of Taxation Twenty Years Later,* Toronto: Carswell, at p 91.
[13] Review of Business Taxation (John Ralph, chair) (1999), *A Tax System Redesigned: More Certain, Equitable and Durable,* Canberra: Treasury, at p 178.
[14] C Sandford, M Godwin and P Hardwick (1989) *Administrative and Compliance Costs of Taxation*, Bath: Fiscal Publications, at p 10.
[15] B Tran-Nam, C Evans, K Ritchie and M Walpole (2000), "Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia", *National Tax Journal* 53(2), at p 233.

dealing with tax authorities.[16] Psychological costs, although not insignificant, are typically subjective and difficult to measure, and for this reason are excluded from the scope of this Report (as is the case in most studies on tax compliance costs).

15. The valuation of incidental costs is also problematic and requires an accounting system providing reliable tracking and apportionment of overhead and variable costs. For this reason, and also because incidental costs are likely to be small relative to explicit labour costs, they have often been disregarded in compliance costs studies, and are also generally ignored in this Report.

16. For the purposes of this Report, therefore, tax compliance costs constitute *explicit* and *implicit* costs of complying with tax obligations.

17. The measurement of explicit costs is straightforward in theory as they are represented by cash expenditures incurred by the taxpayer. In practice, however, difficulties in measurement may arise where tax related and other of types of services such as accounting services are often provided by the same third party and the costs are not easily disentangled. This problem is made even more complex by the fact that it is not always clear in the mind of the taxpayers whether a particular activity (for example record keeping) should be classified as "accounting" or as "tax related". Ultimately there is a fine line between payment to an external party for a service which may simply be a cost of being in business and payment for a cost which arises as a result of an obligation to comply with a requirement of the tax system.

18. The measurement of implicit costs can be even more problematic. For example, the same disentanglement issue exists in relation to internal time. There may be confusion between accounting and tax related activities: the time spent by a business person on core accounting functions such as customer billing and cash monitoring may not be easy to distinguish from the time spent on "pure" tax compliance activities such as completing a GST or VAT return.

19. A key issue related to implicit costs is how to value this internal time. This is a contentious issue which has been abundantly discussed in the literature.[17] For tax compliance activities undertaken by employees of the business, the labour costs can be satisfactorily valued at the prevailing before tax market rates for different categories of personnel. Valuing time spent on tax activities by unemployed proprietors and unpaid helpers is more problematic, and typically research uses a variety of techniques including self-valuation, benchmarking against prevailing market rates for corresponding functions, or combinations of such approaches.

20. As has already been intimated, what constitutes tax compliance activities is by no means straightforward. In addition to the points already made relating to the disentanglement of the costs of accounting or being in business and the costs of complying with tax obligations, there has also been an ongoing (and unresolved) debate about *avoidable* (voluntary) and *unavoidable* (involuntary) tax compliance activities. Clearly the costs of activities associated

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[16] B Tran-Nam, C Evans, K Ritchie and M Walpole (2000), "Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia", *National Tax Journal* 53(2), at p 234.

[17] J Pope (1995), "The Compliance Costs of Major Taxes in Australia", in C Sandford (ed) *Tax Compliance Costs Measurement and Policy,* Bath: Fiscal Studies at p 101.

with the computation of the tax liability (unavoidable) constitute legitimate tax compliance costs. Hence the time taken, or adviser cost incurred, on the calculation of a capital gain or capital loss arising from the disposal of an equity interest would clearly constitute a tax compliance cost. But should the costs of tax planning activities (avoidable) also constitute tax compliance costs? What if the taxpayer incurred considerable advisory costs entering into an elaborate planning activity designed to reduce the liability to tax on the disposal of those equity interests?

21. This Report adopts the view, taken by most researchers in the field, that the costs of all tax related activities (whether unavoidable/compliance-induced or avoidable/planning induced) should be included in the measurement of tax compliance costs. A comprehensive inclusion of all tax related activities is consistent with the broad definition of tax compliance costs (as stated earlier in this Report). This avoids the need to make a discretionary choice of what is and what is not a component of tax compliance costs. Hence, tax planning should be regarded as a legitimate activity of tax compliance. Similarly, tax dispute resolution should also be treated as a legitimate tax compliance activity and incorporated into any comprehensive study of tax compliance costs.

22. A related but different issue is the distinction between *preventable* and *inevitable* costs of tax compliance.[18] Preventable costs refer to those costs incurred by a taxpayer because of poor practice or lack of knowledge in meeting tax legislative requirements (e.g., poor record keeping or not using e-filing). In contrast, inevitable costs refer to those resulting even when a taxpayer uses the best available practice. From a tax policy perspective, the government can only be held responsible for trying to minimize the inevitable costs of tax compliance. However, in practice, it is not possible to distinguish preventable compliance costs from inevitable compliance costs. Hence both preventable and inevitable tax compliance costs are within the scope of this Report.

23. A further distinction – which may be very relevant in the context of the introduction of a CGT regime in New Zealand – is that between *commencement* (or once-off or start-up) tax compliance costs and *recurrent* (or on-going) tax compliance costs. Since tax legislation tends to change continuously, both commencement and recurrent costs exist simultaneously for the tax system as a whole. The presence of commencement costs complicates the analysis of tax compliance in two different ways. First, economic theory and accounting practice suggest that some commencement costs, particularly the costs of durable assets (e.g. a new computer or cash register), should be spread over a number of periods, rather than be treated as a cost solely at the time incurred. In practice, it is problematic to identify commencement costs, let alone allocate such costs over time. Secondly, commencement costs make intertemporal comparisons of tax compliance costs difficult. A researcher may well overestimate compliance

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[18] Inland Revenue (New Zealand) (1997), *Reducing Compliance Costs: An Evaluation,* Wellington: Programme Evaluation Unit, Inland Revenue, at p 75.

costs if he/she investigates them during a period when a new tax is introduced or an existing tax is amended significantly, as costs will decrease in future periods. [19]

24. Another major conceptual issue that has proved to be very important in the literature is the distinction between what have variously been termed total, gross or *social* compliance costs and net or *taxpayer* compliance costs.[20] The former represents the costs to the economy (and is a figure likely to be of greater interest to Treasury and economists). The latter can be taken as the costs directly borne by taxpayers (and is therefore the figure which is likely to be of greatest interest to the business or other taxpayer lobbies and to revenue departments).[21]

25. The difference between social compliance costs and taxpayer compliance costs is primarily accounted for by two factors. In the first place there are various offsetting benefits that are generated for taxpayers as a result of compliance with their tax obligations. These include, fairly obviously, certain cash flow benefits that may arise as a result of the timing difference between receipt of funds and payment of tax relating to those funds. Most modern empirical studies quantify the value of these benefits with some certainty. Less obviously, managerial benefits may also occur as a result of tax compliance. For example, better accounts and record keeping may lead to improved business decision-making and reduce the costs of audit for businesses, resulting in lower accounting fees. These managerial benefits are less easy to quantify than cash-flow benefits, and most major empirical studies have omitted them.

26. The second factor that causes social compliance costs to differ from taxpayer compliance costs is the availability of a tax deduction for many of the compliance costs incurred by business taxpayers. This, as is the case with cash-flow benefits, has the effect of transferring the cost from the taxpayer to society by reducing the flow of tax revenues. The tax deductibility of taxpayer compliance costs has been taken into account in some of the major studies into compliance costs that have occurred in the last 50 years, but, more often than not, has not featured in the studies.

27. In summary, therefore, tax compliance costs for the purposes of this Report are those explicit and implicit costs – whether avoidable or unavoidable, preventable or inevitable, commencement or recurrent – which taxpayers incur, or will incur, in complying with their tax obligations as they relate to CGT. Wherever possible, the likely recurrent costs rather than commencement costs to taxpayers are considered, though where commencement costs are likely to be significant they are separately mentioned given that the Report is concerned with what would be a newly introduced tax. And, wherever possible, the likely impact upon taxpayer (or net) compliance costs are considered rather than the broader (or gross) costs to

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[19] B Tran-Nam, C Evans, K Ritchie and M Walpole (2000), "Tax Compliance Costs: Research Methodology and Empirical Evidence from Australia", *National Tax Journal* 53(2), at p 235.

[20] M Allers (1994), *Administrative and Compliance Costs of Taxation and Public Transfers in the Netherlands,* Groningen: Wolters-Noordhoff; C Evans, K Ritchie, B Tran-Nam and M Walpole (1997), *A Report into Taxpayer Costs of Compliance*, Canberra: Commonwealth of Australia.

[21] Note that North American researchers tend to focus on gross compliance costs, while most European and Australasian researchers tend to consider both.

society. Where relevant and possible, however, the two sets of costs (net or gross) are distinguished.

III. Research Into Tax Compliance Costs: Trends, Causes And Drivers

Research trends: The big picture

28. Three major themes emerge from the literature that has flourished around the world (and particularly in more developed countries) in recent years: compliance costs are *high and significant*; compliance costs are *regressive*; and compliance costs are *not reducing over time*. Each of these themes is explored in more detail below.

29. Compliance costs are *high and significant* for the main central government taxes such as the personal income tax (PIT), the corporate income tax (CIT) and the goods and services tax/value added tax (GST/VAT). They are high however measured – whether in absolute money terms or relative to tax yield, gross domestic product (GDP) or administration costs. For example, empirical studies suggest that compliance costs of such taxes are typically anywhere between two percent and 10 percent of the revenue yield from those taxes; up to 2.5 per cent of GDP; and usually a multiple (of between two and six) of administration costs. In contrast, compliance costs for property taxes are low in absolute and relative terms, as are compliance costs of some excise duties in developed countries (for example, tobacco and petrol) where the sales are high and the number of business taxpayers involved are low. The studies also suggest that tax administration costs are absolutely and relatively less burdensome than tax compliance costs. Those studies that do address administration costs suggest that they rarely exceed one percent of revenue yield, and more usually come in well below one percent.

30. The research also points strongly to the *regressive* nature of compliance costs of such taxes. The size of the business or the income level of the personal taxpayer is a key factor in determining compliance costs, and most of the studies confirm that smaller businesses or lower income taxpayers carry disproportionately higher compliance costs. There are two major reasons for this. In the first place, there are large diseconomies of scale involved in complying with tax requirements, and small firms or low-income taxpayers have to carry the high fixed costs of compliance regardless of the fact that the particular activity or transaction that gives rise to the compliance costs may only occur once or infrequently. Associated with this, there is a learning curve effect that militates strongly against small firms or lower income taxpayers – they may have to commit resources to identify the tax implications of a one-off transaction, compared to a larger business or higher income taxpayer able to amortize that learning cost against a large number of similar transactions. The second reason for the regressive nature of tax compliance costs relates to the indivisibility of factors or inputs used in tax compliance – for example a taxpayer cannot purchase half a computer in order to deal with tax compliance.

31. The evidence from the studies also points to the fact that compliance costs are perceived to be an *on-going cause for concern*. The problem is not perceived as improving over time,

despite attempts by governments (ostensibly) designed to reduce the burden faced by taxpayers. Recent Australian studies into the compliance costs faced by personal taxpayers,[22] small and medium enterprises (SMEs)[23] and large corporations[24] all confirm that tax compliance costs have increased, rather than reduced, in constant dollar terms over time.

Research trends: CGT Compliance Costs

32. After the GST/VAT, there is no tax that has been more widely introduced around the world in the last 50 years than the CGT.[25] However, whilst there is a large and growing literature in the field of tax compliance costs research, it is somewhat surprising to find that there is relatively little of substance written about the compliance costs of taxing capital gains, and that much of what has been written is now relatively dated. It might be thought that capital gains tax would figure prominently in the compliance costs literature. And yet, with some notable and often early exceptions the literature is largely silent upon issues relating to the compliance costs of taxing capital gains.

33. The empirical evidence is therefore limited, and usually only represents a relatively insignificant aspect of a broader study or survey. The following analysis adopts a chronological review of the literature that does exist in this area in each of two countries – the UK and Australia. There is very little specific mention in the literature of the compliance costs of CGT outside these two countries. Some studies from other countries do make references to the impact of capital gains on compliance costs, but these references tend to be tangential at best. For example, Blumenthal and Slemrod note, in relation to the US, that "[t]axpayers who received capital gains income incurred higher total resource costs than those who did not", and later state that "[i]temizing and having capital gains are associated with higher compliance costs…", but otherwise there is no mention of capital gains.[26]

34. The first reasonably comprehensive study of the compliance costs of CGT occurred in the UK in 1969-1970, shortly after the introduction of that tax in its broad form in 1965. In two publications[27] the authors reported upon a survey of the compliance costs of the personal direct taxes in the UK. It was established, inter alia, that the self-employed faced the heaviest costs, that compliance costs were inequitable, regressive and rising, and that they were particularly high for CGT, which emerged as "pre-eminently the tax with high compliance costs:

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[22] B Tran-Nam, P Lignier and C Evans (2014), "Personal Taxpayer Compliance Costs: Recent Evidence from Australia", *Australian Tax Forum,* Vol 29 No 1, pp 137-171.

[23] P Lignier, C Evans and B Tran-Nam (2014), "Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector", *Australian Tax Forum,* Vol 29 No 2, pp 217-247.

[24] C Evans, P Lignier and B Tran-Nam (2016), "The Tax Compliance Costs of Large Corporations: An Empirical Enquiry and Comparative Analysis", *Canadian Tax Journal* Vol 64, No 4, pp. 751-793.

[25] See, for example, C Evans, A Kayis-Kumar and T Russell (2018), *Australian Tax Handbook 2017-18*, Sydney: Thomson Reuters at p 11 which notes that 187 countries out of 220 had a CGT regime in place in 2017.

[26] M Blumenthal and J Slemrod (1992), "The Compliance Costs of the US Individual Income Tax System: A Second Look After Tax Reform, *National Tax Journal*, Vol 45, No 2, pp 185-202, at p 195 and p 200.

[27] C Sandford and P Dean (1972), "Accountants and the Tax System", *Accounting and Business Research*, Vol. 5, Winter, pp 3-37; C Sandford (1973), *Hidden Costs of Taxation*, London: Institute for Fiscal Studies.

complicated, confusing and with horizontal inequities".[28] CGT compliance costs were often high in relation to the tax liability on the capital gain and to the individual's income or capital. Fifty-four out of 56 accountants who provided comments specifically mentioned that the complicated nature of the CGT made that particular tax costly for them to administer on behalf of their clients, and this view was unanimously endorsed by all 14 of the bank advisers who responded. Similarly, 21 accountants mentioned capital gains tax as the most confusing aspect of the tax system to the taxpayer, the largest single mention of any tax under this head.[29] When questioned about the reasons for the heavy compliance costs of capital gains tax, the main reasons given by respondents appear to have been related to issues of record keeping (and consequent problems faced by advisers in obtaining basic data from their clients), and problems of valuation. As noted below, this appears to be a recurrent theme, at least in the UK.

35. It is important to note that these initial studies of CGT compliance costs in the UK were conducted very shortly after the introduction of the tax, and largely relate to commencement rather than recurrent costs. It is usually the case that tax compliance costs become less onerous over time as taxpayers become more familiar with their operation, and this certainly appears to be the case with the CGT in the UK.

36. These early Sandford surveys were followed up in the UK with another Sandford-led study designed to capture the costs to UK taxpayers of PIT and CGT in the 1983-1984 fiscal year.[30] It showed that the CGT compliance costs had, indeed, settled down in the intervening period. Unfortunately, the data from this study also begins to highlight one of the problems that is encountered in any analysis of CGT compliance costs – that information relating to CGT is often integrated with (and incapable of being disentangled from) information relating to income tax more generally, whether PIT as in this case, or CIT in other cases.

37. A 1992 mail survey of approximately 6,000 members of the Tax Faculty of the Institute of Chartered Accountants in England and Wales ("ICAEW") elicited some information relating specifically to CGT.[31] More particularly, it established those CGT areas where compliance costs were likely to be perceived as being high (or low) relative to other areas. As was the case in Sandford's earlier work, valuation issues figured prominently in the list of areas where practitioners agreed that compliance costs were likely to be relatively high. For example, 79 per cent of respondents (the highest percentage) considered that the compliance costs relating to "general dealings with valuation Divisions in respect of CGT" would tend to be high relative to other areas. Other items in the survey involving valuation issues, such as "gifts and bargains not at arm's length" (72 per cent) and "connected persons" (69 per cent), were also among the highest positive response levels. The other aspect that Sandford had identified

[28] C Sandford (1973), *Hidden Costs of Taxation*, London: Institute for Fiscal Studies, at p 145.
[29] C Sandford (1973), *Hidden Costs of Taxation*, London: Institute for Fiscal Studies, at p 94.
[30] C Sandford, M Godwin and P Hardwick (1989) *Administrative and Compliance Costs of Taxation*, Bath: Fiscal Publications, at pp 70-71.
[31] S Green (1994), *Compliance Costs and Direct Taxation*, London: The Institute of Chartered Accountants in England and Wales, at p 36.

as involving high CGT compliance costs – record keeping – also appears to have maintained its high profile by the time of the ICAEW survey. The three other items with the highest degrees of consensus about the relatively heavy CGT compliance costs burden were, respectively, "part disposals" (75 per cent), "re-basing" (73 per cent) and "indexation" (67 per cent). Each of these areas is quite closely connected with issues relating to record keeping, a category that was not separately identified on the survey form. When it came to the identification of specific areas where CGT compliance costs were likely to be lower compared to other areas, the survey provided the largest degree of consensus around "inter-spouse transfers" (75 per cent), "disposals of only or main residence" (69 per cent), and "losses" (68 per cent).

38. Summing up the UK literature on the compliance costs of taxing capital gains, it is fair to say that it is largely historical, somewhat limited (though not so limited as elsewhere in the world) and primarily but not exclusively qualitative and practitioner focused. It suggests that CGT compliance costs are likely to be relatively high, particularly at the outset, as a result of the complexity of the tax itself, and that the burden will be regressive, even though it only affects a relatively small proportion of the taxpaying population. And finally, it identifies specific areas of the tax (record keeping and valuation) that are likely to lead to relatively higher compliance costs than other CGT areas.

39. There is a rather more evidence available in Australia to establish, with some level of certainty, the tax compliance costs specifically relating to the CGT regime. In the early days of the regime, Griffin anecdotally suggested that CGT taxpayer compliance costs were "horrendous" and attributed this to such factors as the complexity of the system, the relevance of CGT for so many transactions, the record-keeping requirements, the need to reconstruct records that had not been maintained, self-assessment and taxpayer ignorance.[32]

40. Empirical research conducted at about that time, however, painted a rather different picture. It estimated that the compliance costs faced by all taxpayers that related to CGT in the 1994-95 year of income were AU$155 million or only 3.3 per cent of all Federal tax compliance costs.[33] This was after offsets such as cash flow benefits and the tax deductibility of certain compliance costs had been taken into account. By way of comparison, income tax (excluding CGT) accounted for about 42 per cent of taxpayer compliance costs, PAYE 15 per cent, Wholesale Sales Tax 11 per cent, the Prescribed Payments System 10 per cent and Fringe Benefits Tax 6 per cent.

41. The general impression that derived from the study of the 1994-1995 compliance costs was, therefore, that for the majority of personal and business taxpayers CGT did not figure prominently as a compliance costs driver. This impression was confirmed, so far as business taxpayers were concerned, when various extrapolations of the data were undertaken to attempt to identify the likely magnitude of CGT and other compliance costs. Once again, CGT figured as a relatively minor component of overall business compliance costs. This is not to imply that

[32] P Griffin (1995), "Is CGT the Most Inefficient Tax?", *Taxation in Australia (Red)*, Vol. 4, Sydney: TIA, at p 45.

[33] C Evans, K Ritchie, B Tran-Nam and M Walpole (1997), *A Report into Taxpayer Costs* of *Compliance,* Canberra: Australian Government Publishing Service, at pp 54-57.

CGT compliance costs should be ignored. Measured on the basis of a comparison of CGT compliance costs (AU$155 million) to CGT revenue for 1994-1995 (AU$994 million), CGT compliance costs represented 16 per cent of CGT revenue. Compared to the percentage figure for all compliance costs relative to all tax revenue (7 per cent), this was high, and implied that CGT was a relatively expensive tax in terms of compliance for those taxpayers affected by it.

42. Subsequent research into the CGT compliance costs of personal taxpayers, SMEs and large corporations conducted by Australian researchers and published in the period 2014 to 2016 suggests that CGT compliance costs continue to be relatively high for those taxpayers affected by the CGT.[34] Note, however, that most taxpayers, whether personal or business, are not significantly affected by CGT. Hence the research also shows, for example, that SMEs spent – on average – only 4 hours per annum (out of a total of 185 hours spent on tax compliance cost activities) on CGT matters.[35] By way of contrast, they spent 69 hours dealing with GST, 36 hours dealing with employee withholding taxes and 33 hours on income tax matters (excluding CGT).

43. A breakdown of the SME compliance costs by size of the business indicates that *micro businesses* (classified as those with turnover up to AU$75,000) spent, on average, 0.4 hours per annum on CGT compliance (compared to 15.8 hours on income tax excluding CGT, 15.7 hours on GST and 37.5 hours in total); *small businesses* (classified as those with turnover between AU$75,000 and AU$2 million) spent, on average, 2.6 hours per annum on CGT compliance (compared to 35.0 hours on income tax excluding CGT, 66.6 hours on GST and 143.6 hours in total); and *medium businesses* (classified as those with turnover between AU$2 million and AU$50 million) spent, on average, 12.4 hours per annum on CGT compliance (compared to 55.4 hours on income tax excluding CGT, 148.5 hours on GST and 482.2 hours in total).[36]

44. For large corporations, the Australian studies established that CGT accounted for only 2.1 per cent of tax adviser costs and 2.6 per cent of internal staff time spent on tax activities. In contrast, income tax (other than CGT) accounted for 66.4 per cent of external adviser costs and 52.9 per cent of internal staff time; GST accounted for 9 per cent and 15.9 per cent respectively; and even Fringe Benefits Tax (FBT) was more costly and time consuming than

[34] B Tran-Nam, P Lignier and C Evans (2014), "Personal Taxpayer Compliance Costs: Recent Evidence from Australia", *Australian Tax Forum,* Vol 29 No 1, pp 137-171; P Lignier, C Evans and B Tran-Nam (2014), "Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector", *Australian Tax Forum,* Vol 29 No 2, pp 217-247; and C Evans, P Lignier and B Tran-Nam (2016), "The Tax Compliance Costs of Large Corporations: An Empirical Enquiry and Comparative Analysis", *Canadian Tax Journal* Vol 64, No 4, pp. 751-793.

[35] P Lignier, C Evans and B Tran-Nam (2014), "Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector", *Australian Tax Forum,* Vol 29 No 2, pp 217-247, at p 238 (Table 10).

[36] P Lignier, C Evans and B Tran-Nam (2014), "Tangled up in Tape: The Continuing Tax Compliance Plight of the Small and Medium Enterprise Business Sector", *Australian Tax Forum,* Vol 29 No 2, pp 217-247, at p 238 (Table 9).

CGT, accounting for 5.3 per cent of external adviser costs and 11.7 per cent of internal staff time. [37]

Summing up

45. A number of important outcomes derive from this review of the literature relating to CGT compliance costs in the UK (primarily historical) and Australia (more recent). To a large extent they mirror the three themes already identified in relation to the broader research into tax compliance costs, with some additional insights related to the nature of the tax itself.

46. In the first place, CGT compliance costs tend to be high, particularly when measured relative to the yield from the tax. They are high because CGT is a complex tax, and one which is the subject of frequent amendment, particularly at the outset. Sandford notes that "[c]apital gains taxes are inherently complicated and inevitably have high compliance and administrative costs", and that "when installed, [capital gains taxes] are probably the taxes most subject to amendment".[38] Evidence to substantiate this judgment is easy to find: in Australia in the period from 1992-1996 (relatively soon after the introduction of the CGT in 1985) no fewer than 10 of the 80 or so tax bills introduced to Parliament dealt with significant CGT changes, and that approximately one quarter of the 700 Taxation Determinations and a dozen or so lengthy tax rulings and four major Pre-consultative Documents in that period were directly related to CGT.[39] But it is important to distinguish between the commencement compliance costs of the CGT and the recurrent compliance costs. Much of the research points to the fact that it is the commencement costs that are particularly high and that, like for other taxes, the recurrent compliance costs are significant but nowhere near as high.

47. Second, the literature suggests that the CGT compliance costs are, like all compliance costs, regressive. Their burden is felt, disproportionately, by those smaller businesses and those on lower incomes who encounter the tax.

48. Third – and again this is a theme common to most taxes – although recurrent costs are not as high as the commencement costs, they do not necessarily reduce over time once the tax has been implemented and bedded down. Here the distinction between the commencement costs of the tax and the recurrent costs is also important. The commencement costs will inevitably be high, and particularly if – as was the case when most regimes were introduced – an opening valuation is required of all assets owned by taxpayers (re-basing). But the interesting point from a review of the literature appears to be that recurrent compliance costs related to the CGT do not necessarily reduce over time for those taxpayers who are affected. It can be hypothesised that this may be a result of structural factors (such as the exemption of pre-1985 assets in Australia), or it may be a direct product of legislative amendment as countries continually tinker with this "unprincipled tax" in attempts to balance equity and

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[37] C Evans, P Lignier and B Tran-Nam (2016), "The Tax Compliance Costs of Large Corporations: An Empirical Enquiry and Comparative Analysis", *Canadian Tax Journal* Vol 64, No 4, pp. 751-793, at pp 778-779 (Tables 5 and 7).

[38] C Sandford C (2000), *Why Tax Systems Differ: A Comparative Study of the Political Economy of Taxation*, Bath: Fiscal Publications, at pp 116 and 100 respectively.

[39] C Evans (1998), "The Australian Capital Gains Tax: Rationale, Review and Reform", *Australian Tax Forum,* Vol 14 No 1, pp 287-323.

efficiency goals (with simplicity often a poor and distant cousin in the process). The ill-fated introduction of taper relief in the UK in 1998, and of the CGT discount in Australia in 1999 bears ample testimony to this process, and the compliance costs it imposes.

49. A fourth conclusion in relation to the compliance costs of the CGT is that they impact only upon a relatively small population of taxpayers. Most taxpayers, personal and business, do not make capital gains on a regular basis and so may only encounter the CGT regime on a one-off or irregular basis. For example, in Australia only 661,564 individuals (out of a total of 13,508,101 individuals who lodged a tax return) returned a net capital gain in the 2015-16 fiscal year – roughly five per cent of all individuals.[40] This is not to minimize the compliance impact of the CGT on those who do encounter the tax, but to ensure that the tax is seen in context.

50. Finally, the cost of tax practitioner advice for taxpayers appears to be a major source of CGT compliance costs, and (in the UK) practitioners identify issues relating to valuation and to record keeping as being key drivers of the compliance burdens in relation to the CGT. In Australia, the relatively small number of individual taxpayers exposed to CGT also appears to spend significant amounts of time dealing with the record-keeping requirements of the CGT regime.

Causes and drivers

51. Some of the factors that may help to determine the level and incidence of compliance costs have already been mentioned. Clearly, the size of the business (or income of the personal taxpayer) is one such factor, and the type of tax (for example, direct versus indirect, personal versus corporate) as well as the particular nature of the taxpayer (business versus non-business) will also have a significant bearing on compliance costs. Other research has identified the importance of such factors as the manner in which the business is transacted (i.e. the legal form of the business), the industry or sector in which the business operates, and a host of related variables, as further critical determinants of the compliance burden.

52. But three particular factors stand out as major, over-riding determinants of the compliance costs of CGT: *change*, *complexity* and *choice/the quest for fairness*.

53. As noted in a 2006 KPMG report "change creates both cost and uncertainty".[41] *Frequent change* in legislation, or the introduction of new legislation, can significantly impact upon the compliance burden, and it does not matter whether that change is as a result of the introduction of a relieving provision or the introduction of an integrity measure designed to protect the revenue base. In this sense, "an old tax is a good tax". The notion is that change interferes with the smooth operation of the tax administrative machinery that facilitates the interactions that necessarily occur between taxpayer and revenue authority, which takes time to settle down to cope with change. Research by Evans which considered the major drivers of the compliance costs of the capital gains tax for personal taxpayers in Australia and the UK,

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[40] Australian Taxation Office (2018), *Taxation Statistics 2015-16*, Canberra: Australian Taxation Office, at Table 3.

[41] KPMG, (2006), *Administrative Burdens – HMRC Measurement Project*, London: KPMG LLP, (March), at p 6.

confirmed that "frequency of change" was considered to be one of the two most significant of the causes of the compliance burden – the second being complexity.[42]

54. *Complexity* is clearly a major determinant of the compliance burden. But it is important to recognize that there may be different forms of complexity at work. In the first place there is *legislative* complexity. Taxing capital gains is not straightforward, and it is possible to identify a number of layers in this statutory complexity. There is, for example, "technical complexity" which relates to the level of understanding or comprehensibility of a particular legislative provision in isolation. Often, this technical complexity is a product of the policy considerations underlying the particular provision. Prime examples of technical complexity in the Australian CGT regime would be the operation of the scrip for scrip roll-over provisions, the rules for the main residence exemption, or the CGT small business concessions.

55. There is also "structural complexity" (sometimes referred to as transactional complexity), which relates to the way in which laws are interpreted and applied, and which can affect the certainty and manipulability of legislative provisions. In the Australian CGT, the existence of separate rates of tax for revenue gains and capital gains leads to excessive tax planning (and therefore high voluntary tax compliance costs) designed to achieve the alchemy of transforming highly taxed income into preferentially taxed capital gains. This is a prime example of structural complexity, as is the complexity introduced as a result of the decision to "grandfather" capital gains realized on the disposal of assets acquired before 20 September 1985 (see below).

56. Alongside this statutory complexity there is also *effective* complexity, which emphasizes the interaction of the tax law and the population of taxpayers. It relates to the variety of record-keeping and form-completing tasks a taxpayer must perform to comply with the tax laws. This final layer of complexity is neatly described in the KPMG report as "grit in the system" – the way that the taxpayer interacts with the revenue authority at the operational, day-to-day, level.[43]

57. Taxpayer compliance costs are often, ironically, the product of tax policy and tax law designed to offer taxpayers *choice*, often itself the product of a *quest for fairness*. Choice can help to reduce the burden of tax and provide a more equitable tax system than would otherwise be the case; but such equitable outcomes often come at the price of a higher compliance burden. The personal taxpayer in Australia, given the choice of calculating the amount of capital gain she or he will face on the basis of two or more different methods of computation, will almost certainly incur high compliance costs (in computing the outcome under all available methods) in order to reduce the tax bill by a few dollars by choosing the method which produces the least tax outcome. It is not entirely rational, but it is behaviourally understandable and perhaps inevitable. There are occasions and situations where better compliance burden outcomes can be achieved by reducing the amount of choice and by opting for a greater degree of simplicity rather than seeking the ultimate level of equity. There is always a need to consider the trade-off between simplicity and equity. Sometimes a rough and ready outcome that may not be

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[42] C Evans (2003), *Taxing Personal Capital Gains: Operating Cost Implications,* Sydney: Australian Tax Research Foundation, at p 195.

[43] KPMG, (2006), *Administrative Burdens – HMRC Measurement Project*, London: KPMG LLP, (March), at p 6.

entirely fair but which is reasonably simple may be the better outcome. This is often the case in taxing capital gains.

58. A misguided quest for fairness, to the detriment of simplicity, may be responsible for what is possibly the one factor that has added the greatest complexity to the Australian CGT regime since its introduction – the decision to grandfather capital gains in relation to all assets acquired before 20 September 1985 (the commencement date for the Australian CGT), rather than simply exempt that portion of the gain that had accrued prior to that date (as has been the case in all other countries introducing a CGT). It has been noted that this single decision has meant that the Australian CGT regime is far more complex than otherwise would need to be the case, and that up to 20 per cent of the volume of the Australian CGT legislation is attributable to this mistaken decision to grandfather.[44] Although the volume of legislation and the burden of tax compliance do not always directly correlate, there is little doubt that the decision to grandfather would have contributed a large part of the total CGT compliance costs in Australia.

IV. Proposed CGT Design Features And Implications For Tax Compliance Costs

59. The TWG Interim Report discusses, in Chapter 6 and Appendix B, a number of design features that the proposed CGT might incorporate. This Report now considers the tax compliance cost implications of these design features, adopting the TWG Interim Report structure of *what to tax*, *when to tax* and *how to tax*.

What to tax

60. The tax base for the proposed New Zealand CGT is more or less comprehensive; it builds upon the existing capital base by identifying and including a list of asset classes that are not currently subject to tax (interests in land, intangible property, all other business or income-producing assets that are not already taxed on sale, shares in a company and certain choses in action). As such, the base does not differ in any significant detail from that adopted in comparable "Commonwealth"[45] regimes: the inclusion of capital gains on the disposition of all assets with the exception of the family home and certain personal use assets.

61. In general terms, the more comprehensive the base, the less likely that there will be adverse tax compliance cost implications. A partial base inevitably gives rise to uncertainty as taxpayers seek to determine whether their asset or transactions falls within or outside the base. It also gives rise to costly arbitrage activity, as taxpayers and their advisers seek wherever possible to ensure their transaction falls with any possible exclusion, exception or exemption. The more there are opportunities for uncertainty or for arbitrage activity to take place, the

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[44] C Evans (1998), "The Australian Capital Gains Tax: Rationale, Review and Reform", *Australian Tax Forum,* Vol 14 No 1, pp 287-323, at p 315.

[45] A term used by HJ Ault and BJ Arnold in (2010), *Comparative Income Tax: A Structural Analysis,* Den Haag: Kluwer Law International, at pp 237-238 to distinguish the tax systems of countries like the UK, Canada, Australia and New Zealand from the "Continental" (France, Germany, Netherlands etc.) and the US tax systems.

higher the compliance costs will be. Hence the decision that the base should be as comprehensive as feasible has positive implications so far as compliance costs are concerned.

62. The exclusion of the family home from the CGT base is in line with the treatment in virtually all countries with a CGT regime (Indonesia is an exception) and is hardly surprising. The compliance cost implications will depend very much on the precise details of the exclusion and can pull in different directions. On the one hand the creation of a "divide" (between asset classes that are within and outside the tax base, and between dwellings that can attract the favourable tax treatment and dwellings that cannot) may lead to increased tax compliance costs as taxpayers seek to take advantage and so planning costs increase; but on the other, excluding the family home will, in most circumstances, prevent personal taxpayers from having to maintain copious records over long periods of time relating to all sorts of ownership costs. On balance, and subject to detail, the exclusion of the family home is likely to have positive compliance cost implications given that record keeping (as noted in Section III) is such a substantial part of tax compliance activity.

63. As noted in the TWG Interim Report, there are a number of design issues relating to the family home exclusion that will need to be resolved before the full tax compliance cost implications can be assessed: the definition; the treatment of married/civil union/de facto couples; the tax residency status of the owner; ownership through different vehicles; absences; mixed and changing use; and expensive homes. All of these factors have the capacity to impact upon the tax compliance costs associated with the exclusion of the family home from CGT, and often in a negative fashion. For example, it can be expected that planning activity (and therefore tax compliance costs) will increase if a distinction is drawn between "mansions" (within the charge to tax) and other family homes. Some countries (notably the US and South Africa) have imposed a cap on the amount of the tax-free capital gain that can be taken on the family home, accompanied, in the case of South Africa, by a test based on the capital proceeds from the disposal (which usually avoids the costly need to calculate the capital gain). There are clearly tax compliance cost implications – whether of an avoidable (planning) or unavoidable (computational) nature – that need to be considered if such a distinction were to be drawn in the proposed New Zealand CGT.

64. Nonetheless, carefully written legislation on the exclusion of the family home, combined with a wealth of Commonwealth tax jurisprudence on issues related to the family home, should provide a sound basis for ensuring its exclusion from the tax base should not cause tax compliance cost implications that are too adverse. In this regard, it may prove useful to consider the re-written Australian CGT legislation relating to the main residence exemption (Sub-division 118-B of the Income Tax Assessment Act 1997) as a guide to well-written and clear statutory provisions which may help to mitigate tax compliance costs – which is not always (or often) the case with Australian tax legislation.

65. The second major exclusion suggested in the TWG Interim Report is for personal use assets (cars, boats and other household durables). Again, this is very much in line with international best practice. Overall the exclusion of the large number of assets that fall under this "umbrella" would be likely to decrease tax compliance cost considerably. Maintaining records for such assets would be very costly and – given that most of such assets would lead to capital losses rather than capital gains – it would invite considerable numbers of personal

taxpayers to engage with the tax system (in order to claim their losses) who would otherwise not have to engage. As noted earlier, the fewer the number of taxpayers involved, the lower the overall level of tax compliance costs.

66. The TWG Interim Report also suggests that certain higher value items such as jewellery, fine art, antiques and other collectibles (rare coins, vintage cars etc.) would also be treated as personal use items and so be exempt. International practice on such higher value items is mixed. Some countries, for example South Africa, exclude such items from the tax base. Others, for example Australia, consider the potential loss of revenue from excluding such assets to be too great and so include them in the taxable base of the CGT, subject to de minimis exclusions. The approach proposed for New Zealand – to exclude such assets – will certainly operate to reduce compliance costs, although potentially at a possibly significant cost to the revenue. If this loss of revenue is considered to be too high, the “best second best” from a compliance cost perspective may be to adopt the Australian position and exempt such “collectables” (the Australian term) only where their cost is AU$500 or less, ensuring that taxpayers do not need to keep records for the greater amount of collectables, those with a cost base below the limit.

67. The proposal to include real property in the tax base (albeit excluding the family home) has clear compliance cost implications for any holders of holiday homes, baches, cribs and other second homes. Owners will be required to keep extensive records for long periods of time, although the proposal that costs of a revenue nature (insurance, rates etc.) would not form part of the cost base will help to reduce these costs. It is notable that the Australian CGT rules do permit a deduction for on-going revenue costs of holding the property, and there is no doubt that this increases taxpayer compliance costs.

68. The proposal to exempt the disposal by New Zealand tax residents of certain homes outside New Zealand where the gain is taxed overseas or where a comparable overseas CGT regime applies is entirely sensible from a compliance cost perspective.

69. Overall, therefore, the suggested design features relating to the tax base – the consideration of *what to tax* – point to a design that should not lead to excessive compliance costs. A comprehensive base with minimal but carefully designated exclusions should ensure that tax compliance costs are kept to the minimum possible.

When to tax

70. The TWG Interim Report identifies two key considerations in relation to the decision of “when to tax”: the adoption of a realization rather than an accruals basis for taxing capital gains in most cases; and the extent to which deferral or roll-over provisions would figure in the design of the CGT regime.

71. The presence of a true market valuation in the overwhelming majority of disposals (sales) of assets within the CGT is a powerful argument for the adoption of the realization basis, notwithstanding problems such as lock-in and bunching. This readily available market price removes many of the (high compliance cost) valuation problems that would occur if an accruals basis were instead adopted. As noted earlier, valuation, along with record keeping, is

consistently cited as one of the major drivers of high compliance costs in CGT regimes. The minor carve-out involving an accruals regime using the current fair dividend rate for shares in foreign companies (other than certain Australian listed shares) is unlikely to have an adverse impact on compliance costs (even though it involves an annual valuation) given that market values of these equities will be readily available and the regime is already in operation. Hence there are unlikely to be any serious tax compliance cost implications deriving from the decision to operate on a realization basis for actual disposals.

72. There are, however, more serious compliance cost implications arising from the proposals relating to deemed (as opposed to actual) realizations. It is suggested that certain of these deemed realizations, such as when assets leave the New Zealand tax base (for example, where a New Zealand resident migrates), may give rise to an immediate charge to tax. This may cause some compliance burden, requiring as it does a valuation of assets within the CGT net. But the burden is not likely to be high and can – in any case – be mitigated by the adoption of a rule (as in Australia, and as suggested by the TWG Interim Report in paragraph 140 of Appendix B) that permits the departing resident the opportunity to accept that the assets remain within the New Zealand CGT net until their ultimate disposal.

73. But the situation where a deemed disposal (usually for no consideration) occurs and some form of deferral of the charge to tax is offered may be more problematic from a compliance costs perspective in a number of other circumstances. Roll-over reliefs are a necessary part of any CGT regime, but it is inevitably the case that the broader the range of roll-overs that are available, the higher the compliance costs will be. Each roll-over imposes a further layer of statutory complexity and therefore imposes incremental tax compliance costs.

74. The TWG Interim Report identifies a large number of potential roll-over reliefs including the possibility of a roll-over on death (particularly for inter-spousal dispositions), on gifts, on distribution by a trust or company to a beneficiary or shareholder and in relation to marital and relationship breakdowns. Although it is not yet clear from the TWG Interim Report to what extent these, and other potential roll-overs identified such as involuntary dispositions of business assets (for example as a result of compulsory acquisitions or natural disasters), like-for-like roll-overs (such as scrip for scrip or business re-investments), corporate re-organisations (including de-mergers and amalgamations) or intra-group transactions, will figure in the final CGT design, it is clearly the case that each additional roll-over or deferral mechanism will add additional complexity and additional tax compliance costs. Ultimately the decision as to which forms of roll-over are included will involve the necessary trade off involving the standard efficiency and equity tax policy goals balanced with the impact upon revenue and the desire for simplicity.

75. In summary, therefore, the compliance cost implications of the proposed design features relating to *when to tax* are mixed. On the one hand the decision to adopt a realization basis will help to minimize such costs; but inevitably each roll-over introduced will add structural complexity and potentially add to the compliance cost burden. But this may be a necessary and acceptable trade-off.

How to tax

76. The TWG Interim Report in relation to *how to tax* capital gains contains a number of suggestions that should operate to ensure CGT compliance costs are less onerous than has been the case in many other jurisdictions that have introduced a CGT regime, both in terms of commencement and recurrent compliance costs. More particularly:

- the use and extension of the existing tax law framework (of the Income Tax Act 2007 and the Tax Administration Act 1994) should provide a simplification dividend as a result of familiarity for taxpayers and their advisers with existing law and procedures, and as a result of the possible repeal of some existing provisions as noted in the TWG Interim Report;[46]

- taxing capital gains in the same way as any other income is taxed (unless there is good reason to do otherwise) will have a significant downward impact on potential costs of compliance. Compliance costs (and particularly the avoidable or voluntary costs associated with tax planning) tend to be higher where differing forms of income are taxed in different ways, providing an incentive for arbitrage and gaming activity to seek a lower tax burden;

- for the same reason, the suggestion that there would be no discount for capital gains will also help to ensure compliance costs are minimized. As noted in the TWG Interim Report "Applying a discount or different tax rates to different asset types causes significant classification issues as between capital gains assets and revenue assets…. Any discounted approach would reduce the amount of legislative simplification that could be achieved…..".[47] The introduction of the 50 per cent CGT discount in Australia in 1999 has almost certainly increased overall compliance costs as a result of the added incentive it gives for extensive CGT planning designed to take advantage of the discount. It has also added significantly to the complexity of the legislation. It involves excruciating legislative complexities which are encountered in the interaction of the discount provisions with rules relating to specific forms of entity, such as the trust provisions, and in the tortuous interaction with the small business concessions. Another source of complexity is the existence of a series of necessarily detailed integrity measures that necessarily have to accompany the discount;

- the decision that indexation of the cost base to account for inflation should be avoided will also enable New Zealand to side-step the significant CGT compliance costs resulting from sometimes time-consuming and complex computations that can be involved in indexed systems (for example where equities are acquired in various tranches and involve share splits, bonus and rights issues etc.). Indexation would have been one of the reasons for high Australian computational compliance costs in the period from 1985 to 1999;

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[46] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 151.
[47] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 151.

- collecting the tax in the same way as income tax is currently collected will mean there only negligible compliance cost implications relating to the collection of tax; and

- the sensible approach proposed to the taxation of non-residents will also help to ensure that CGT compliance costs are not exacerbated. By adopting international best practice (and leveraging off existing rules) and limiting non-resident liability to capital gains only to assets that are clearly (and usually physically) connected to New Zealand, both statutory and effective tax complexity can be avoided and compliance costs minimized.

77. The proposals suggested with regard to the transitional or introductory rules will potentially have a mixed impact upon likely commencement and recurrent CGT compliance costs. The TWG Interim Report identifies two possibilities: CGT could apply for all affected assets from a certain date (the "valuation day" approach); or CGT could apply by only taxing gains on assets acquired on or after the introduction date (the "Australian grandfathering" approach).[48]. The TWG Interim Report indicates that it prefers the valuation day approach.

78. As is recognized in that Report, this will cause relatively high compliance costs because of the "need to value all assets that are to be subject to the new rules as at a given day. This will impose a significant cost on many taxpayers for certain asset types." As noted earlier in this Report, the need for valuations has been identified as one of the main drivers of CGT compliance costs. Two possible modifications of the valuation day approach are contained in the TWG Interim Report. The first is to adopt the Canadian median approach, which involves a valuation based upon comparison of actual costs, value on valuation day and sale price. This would, however, be very unlikely to reduce the compliance costs burden and would more likely increase them. The second set of (pragmatic) suggestions is to base the valuations upon rateable values (for real property), fair market value (for assets subject to IFRS rules) and to offer time apportionment of the gain for other hard to value assets. Although providing taxpayers with choices is not always a sensible way to seek to reduce compliance burdens, on this occasion the pragmatic approach may be a sensible outcome and will certainly help to mitigate tax compliance costs.

79. Moreover, in suggesting the valuation day basis (subject to these pragmatic adaptations) rather than the Australian grandfathering approach, the TWG Interim Report sensibly avoids imposing upon New Zealand taxpayers what is arguably the single largest determinant of tax system complexity in Australia – the legislation (including its manifold integrity measures) designed to ensure that tax is not imposed on gains that arise from any assets acquired before the introduction of the CGT in September 1985.

80. There are other aspects of the proposed design features where it is not possible to determine, with any degree of confidence, what the compliance cost implications might be. The treatment of capital losses outlined in the TWG Interim Report is one such area. Traditionally, all capital losses are ring-fenced in CGT regimes in recognition of the portfolio choice that is available in relation to the timing of capital asset disposals. To the extent that capital losses cannot be offset against capital gains in one fiscal year, they are carried forward to be available against future capital gains. The computational and planning issues surrounding

[48] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 155.

capital losses are therefore relatively straightforward, and associated compliance costs are relatively low in traditional CGT regimes. If different loss treatments are envisaged for different asset classes in the New Zealand regime (which appears to be the conclusion of the TWG Interim Report[49]), it is possible that these compliance costs might not be as low as would otherwise be the case.

81. Other areas where it is difficult to predict with any degree of certainty the likely compliance cost implications include the proposals relating to the possible modification of the taxation of shares in foreign companies,[50] the taxation of New Zealand shareholders in New Zealand tax resident companies[51] and the taxation of KiwiSaver and other managed investment entities.[52] Inevitably the compliance cost implications will depend upon the detailed rules which are still to be developed and the choice of options that are outlined in the TWG Interim Report.

82. Summing up, there are potentially mixed implications that derive from the design features of *how to tax* capital gains. Many of the proposed features should help to keep compliance costs down; others, however, may lead to higher compliance costs; and for those where the fine detail is still to be determined, it is not possible to predict the compliance cost implications with any confidence.

83. Nonetheless, the overall design features (entailing considerations of *what to tax*, *when to tax* and *how to tax*) for the proposed New Zealand CGT regime suggest that the compliance costs would not be excessive and would certainly compare favourably with those in most CGT regimes. In terms of straight comparison, it can reasonably be argued that the New Zealand CGT compliance costs, both commencement and recurrent, could expect to be lower than those in Australia for the reasons contained above.

V. FURTHER MEASURES TO MITIGATE TAX COMPLIANCE COSTS

84. It has been noted that tax compliance costs are regressive, and that this is also likely to be the case with CGT compliance costs. This section identifies and considers three sets of measures that some have suggested may help to address this disproportionate burden. The first of these addresses a concern raised in the TWG Interim Report about additional filing requirements that may arise from the introduction of a CGT[53] and provides a degree of protection for personal taxpayers with relatively minor capital gains. The second considers the case for special concessions for small businesses, and the third identifies measures that the

[49] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at pp 154-155.
[50] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at pp 157-159.
[51] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at pp 161-166.
[52] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at pp 167-172.
[53] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 151 and pp 179-180.

Inland Revenue can undertake to help mitigate tax compliance costs arising from the introduction of a CGT.

An annual exempt amount

85. The TWG Report expresses the concern that "many taxpayers who have not previously needed to interact with Inland Revenue are likely to be required to do so" as a result of the introduction of a CGT.[54] This will certainly be the case if all taxpayers are required to submit returns for all capital gains. It is difficult to envisage that the TWG Interim Report's preliminary views involving modifications to withholding tax and provisional tax regimes will go very far in addressing this problem. Moreover, imposing additional information obligations on taxpayers (such that they annually file documentation relating to assets they possess) as suggested in the TWG Interim Report will only exacerbate tax compliance costs, and potentially by a considerable degree.

86. There may, however, be a simpler and more effective solution. A notable feature of some overseas CGT systems is the use of an annual exempt amount (AEA), whereby an initial amount of capital gains realized by personal taxpayers (and sometimes trustees) in a fiscal year is relieved from taxation completely. The UK has the most pronounced example of an AEA in operation, with (in the fiscal year ending on 5 April 2019) an AEA of £11,700 (approximately NZ$22,500 at November 2018 conversion rates). South Africa also has an AEA for capital gains, currently standing at R40,000 (approximately NZ$4,100 at November 2018 conversion rates).

87. If one accepts that CGT is an inherently complex tax, and one which imposes significant compliance costs on personal taxpayers (and sometimes cost recovery problems for practitioners), one of the most effective ways of achieving some measure of simplicity is to institute a provision that minimizes the number of taxpayers who are liable for this tax. As noted above, this has been achieved in tax jurisdictions such as the UK and South Africa through the use of an AEA, where (proportionately) considerably fewer taxpayers are required to submit returns than is the case in countries such as Australia without an AEA.

88. Research conducted in Australia in relation to the 2012-2013 fiscal year considered the impact that the introduction of an AEA, in place of the 50 per cent CGT discount, would have on the overall simplicity of the Australian CGT regime.[55] It established that the replacement of the 50 per cent CGT discount with an AEA in Australia would achieve increased simplicity through removing from the CGT net significant numbers of taxpayers who have a CGT liability under the current system. It estimated the number and proportion of taxpayers in 2012-2013 who would no longer face a CGT liability at two proposed levels of an AEA threshold: AU$10,000 and AU$1,000.

89. At the higher threshold for the AEA, the number of taxpayers with a resultant net capital gain of zero was 274,940, which was 71 per cent of the taxpayer population who had a taxable

[54] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at pp 167-179.
[55] C Evans, J Minas and Y Lim (2015), "Taxing Personal Capital Gains in Australia: An Alternative Way Forward", *Australian Tax Forum,* Vol 30 No 4, pp 735-761.

net capital gain in that year. If the AEA were set at AU$1,000, this would have resulted in 167,750 taxpayers without a taxable net capital gain, representing approximately 43 per cent of the individual taxpayer population with a taxable capital gain in 2012-13. The research concluded that "the simplicity dividend of permitting up to 71 per cent of existing taxpayers to avoid the requirement of dealing with such a complicated part of the existing personal tax system is an enticing prospect".[56]

90. The introduction of an AEA would, of course, mean that some of the revenue from the introduction of a CGT would be lost. However, the research conducted in Australia established that this revenue foregone is not substantial. Most capital gains, by value and size, are made by the wealthier and higher income sections of society, and so most capital gains by value and size would continue to be taxable. The research established that the revenue cost of an AEA set at AU$10,000 would be approximately AU$578m, representing the loss of roughly 10 per cent of CGT revenue for the year. In the event that the AEA was set at AU$1,000, the revenue cost, based on the same year, would be approximately AU$93m, or less than 2 per cent of CGT revenue. This appears a small price to pay for removing such substantial numbers of taxpayers (71 per cent and 43 per cent respectively) from the need to file annual returns.

91. It is therefore suggested that in order to minimize the compliance costs associated with a CGT, consideration be given to the introduction of an AEA to remove the "minnows and tiddlers" from having to compute and return capital gains. The amount of the AEA would need to be determined on the basis of a careful calibration of the likely capital gains profile of New Zealand taxpayers together with analysis of overseas experience – arguably the current UK threshold of over NZ$20,000 would be excessive, but a figure at the lower end of, say, NZ$1,000 might be just as absurd. The compliance benefits of such a low threshold would scarcely outweigh the costs of implementation and application. The appropriate figure is probably somewhere in between, and probably towards the lower end of the range.

92. But whatever threshold was determined, it would also be important to integrate into the design of the AEA a secondary trigger based upon a multiple of the capital proceeds. This would obviate the need for CGT advice to be sought and costly calculations to be undertaken in obvious situations where the taxpayer could easily identify that the capital proceeds in a fiscal year fell below, say, twice the annual exempt amount. The capital gain computation on a few bank shares sold by a widow to supplement her lifestyle might be inherently complex if the shares were acquired on different dates with different cost bases, and involved rights issues, bonus issues and dividend reinvestment plans; however if she (or her family) was able to quickly identify that her sale proceeds were below the de minimis of twice the AEA for that year and that no CGT computation or return was necessary, the outcome would eliminate virtually all compliance cost implications.

93. Hence any proposed AEA would allow personal taxpayers to qualify for a complete exemption from any CGT liability by meeting one of the following two criteria:

(1) the net capital gain for the income year is equal to or less than the AEA; or

[56] C Evans, J Minas and Y Lim (2015), "Taxing Personal Capital Gains in Australia: An Alternative Way Forward", *Australian Tax Forum,* Vol 30 No 4, pp 735-761, at p 751.

(2) the total capital proceeds from all relevant CGT events for the personal taxpayer in the income year are equal to or less than an amount which is (say) twice the AEA.

94. Typically, the proposed AEA would still operate as a CGT-free threshold for those taxpayers with a net capital gain in excess of the threshold. That is, its purpose is not only to exempt from CGT those taxpayers who meet one of the above criteria, but it will also allow taxpayers with net capital gains above the AEA threshold to be able to apply the AEA to reduce their taxable capital gain by the amount of the AEA. Note, however, that the CGT AEA is usually non-cumulative — to the extent that a personal taxpayer is unable to use part or all of the AEA in a given tax year, it is not available to be carried forward or backward to other fiscal years.

95. Under this proposal it is suggested that the operation of the capital loss and AEA provisions should be on a similar basis to the equivalent provisions in the UK. In the first instance, the taxpayer would be required to apply all current year capital losses to their capital gains. If the resultant amount was less than the AEA, the taxpayer would have no capital gains tax liability. If, however, the amount was more than the AEA and the taxpayer had capital losses from previous years, they could apply these brought-forward capital losses to their current year capital gains. If the capital losses from prior years did not reduce capital gains to the AEA threshold amount, the taxpayer would be liable for CGT on the remaining capital gain after applying current and prior year capital losses and the current year AEA.

96. The introduction of an AEA might also lead to some new complexities (including the need for integrity measures), but the experiences of both the UK and South Africa in this regard would appear to suggest that these would not be significant. Clearly, taxpayers have discretion on the timing of their CGT realizations and, as a result, they may time these to occur when their CGT liability will be lower. In a tax regime with an AEA, taxpayers may choose to realize an amount of capital gains up to the limit of the AEA each year and to the extent that they are successful in doing this, they may avoid any CGT liability. Techniques designed to achieve this include end-of-year bed and breakfast or wash sale schemes,[57] or fragmentation[58] or splitting[59] of assets. However, various successful "policing" mechanisms already exist in overseas jurisdictions using an AEA,[60] and the overall impression that is gained from analysis relating to the use of AEAs in overseas jurisdictions is that it is a preference that has not been overly abused, and that the leakage that does occur is probably a necessary and realistic trade-off for the simplicity benefits it brings to the regime.

[57] Under these techniques, individuals dispose of appreciating assets – particularly quoted shares – at the end of one fiscal year and immediately re-acquire them at the beginning of the next, in order to create a gain that can be relieved by the annual exempt amount (which would otherwise be lost if not used in a year of assessment) and obtain a tax-free uplift in the base cost of the assets as a result of the transaction.

[58] Under this technique, the intention is to increase the number of the disposer's exemptions by fragmenting the disposal over two or more tax years.

[59] Here, the intention is to increase the number of disposers by spreading the ownership of the asset, usually by gifting. A single asset may be split into fractional interests, or a shareholding divided. The donees are typically spouses, minor children or other relatives.

[60] See, for example, s 16A of the *Taxation of Chargeable Gains Act 1992* (UK) which targets arrangements intended to avoid UK tax through the creation and use of contrived capital losses.

97. Moreover, although realising capital gains up to the AEA can be relatively easily achieved with some types of capital gains assets such as shares (albeit with transaction costs in the form of duties and brokerage fees), it cannot be achieved so easily for other types of capital gains assets such as real estate, where the size of the capital gain is significantly larger than the proposed AEA levels. Hence the nature of the asset can act as a further policing mechanism

Small business measures

98. Angel Gurria, the Secretary-General of the OECD, has noted that "SMEs are the economic backbone of many of our economies and they serve as key engines for job creation".[61] Given their vital importance to most economies, including that of New Zealand, and given the regressive nature of tax compliance costs, it is therefore tempting to argue that any CGT regime proposed for New Zealand should include tax preferences and simplification measures to alleviate the compliance burden for the small business sector.

99. However, the case is not as straightforward as might at first be imagined. Whilst the provision of SME-specific tax rules can play a useful role in addressing the challenges and the disproportionately high tax compliance burdens faced by SMEs, any such measures need to be carefully designed and approached with caution.

100. The OECD notes, in this connection, that "when introducing special tax rules for SMEs, care should be taken to ensure that these measures do not increase complexity. The costs associated with tracking eligibility, keeping specific records and interacting with the tax system for multiple different preferences or simplification measures can increase the complexity of the system. In this regard a simpler general tax system may be more advantageous to SMEs than a series of simplification measures".[62]

101. Australia's experience bears testimony to this advice. Its policy and technical experience with CGT small business concessions has been variable and confusing over the years. Initially (at the design stage in the period prior to 1985) no special treatment for the small business sector was to be afforded within the CGT regime. This changed almost immediately when one small concession was introduced in 1985. By 1997 there were three specific concessions, with messy legislative provisions that were virtually unworkable. "Rationalisation" and "reform" in 1999 led to an increase to four in the number of special CGT provisions for the small business sector, but no less concern about the workability of the legislation. Major changes in the period after 1999, particularly in 2006 and 2007 and again in 2016 and 2017, have not improved the position.[63]

102. As a result, taxpayers and practitioners are still, in the main, confused, and see the small business concessions as a major source of systemic compliance costs in the Australian CGT

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[61] Cited in the Foreword of OECD (2015), *Taxation of SMEs in OECD and G20 Countries*, Paris: OECD Tax Policy Studies, No. 23.

[62] OECD, (2015), *Taxation of SMEs in OECD and G20 Countries*, Paris: OECD Tax Policy Studies, No. 23, at p 15.

[63] The current Australian CGT small business concessions are detailed in the Appendix.

regime. What was conceived of as an attempt to reduce tax compliance costs for SMEs in the early years of the Australian CGT regime has resulted in far greater complexity and higher compliance costs, albeit with a very generous small business regime offering four different concessions.

103. Moreover, the concessions suffer from a lack of any coherent policy, are very expensive (to the extent that they may be becoming unsustainable) and are not well targeted. Most recent estimates suggest that their annual cost is over AU$6 billion and that they are increasingly being accessed by individual and corporate taxpayers who would not normally be regarded as fitting the profile of small business taxpayers.[64]

104. Given this Australian experience, it is difficult to recommend that New Zealand follow the Australian model and offer any concessional CGT treatment to the SME sector on the grounds of compliance cost mitigation. It is not clear that the introduction of any one or all of the four Australian CGT small business concessions (see Appendix) would help to reduce the tax compliance costs of SMEs. There may be other policy grounds for introducing such concessions, such as facilitating business growth – apparently the underlying policy rationale for the small business roll-over (the fourth concession in the Appendix) – or providing improved retirement outcomes for small business owners who, being typically cash-constrained, tend to invest surplus funds in their business, treating it effectively as their retirement "nest egg" (apparently the rationale for first, second and third Australian CGT small business concessions in the Appendix). But in the absence of any such compelling reasons, the advice of the OECD on the matter may be more appropriate: a simpler general tax system may be more advantageous to SMEs than a series of simplification measures designed specifically for the SME sector.

Inland Revenue assistance

105. The third area where specific measures may help to address the regressive burden imposed by tax compliance is in the scope and nature of the assistance that the revenue authority may be able to provide to make compliance as easy and costless as is possible. The New Zealand Inland Revenue operates at the forefront of international best practice, and it would be expected that it would play a significant role in helping to contain CGT compliance costs.

106. The following paragraphs provide high level guidance and indicate some broad principles on how the Inland Revenue may play a role in mitigating CGT compliance costs.

107. The compliance costs of the taxpayer and the administration costs of the revenue authority together comprise the operating costs of the tax system, and their relationship with each other is an important aspect of the overall picture. Often compliance costs and administration costs move in the same direction. For example, a simplification of the tax system is likely to reduce both sets of costs, while the introduction of a new tax will usually increase both sets of costs. In similar vein, if a tax system is being inefficiently administered

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[64] Australian Treasury (2017), *Tax Expenditures Statement*, Canberra: https://treasury.gov.au/publication/2017-tax-expenditures-statement/ Items C7, C12, E24, E29.

(with consequent high administration costs) the inefficiency is also likely to translate to high compliance costs for taxpayers as they struggle to deal with the consequences of the poor tax administration. Moreover, taxes with high compliance costs (such as the GST/VAT and CGT) are often taxes that also have high administration costs.

108. Note, however, that administration costs may sometimes be inversely related to compliance costs, in that an increase in one may cause a fall in the other. For example, in a system of self-assessment, it is quite likely that the compliance cost burden on taxpayers will increase as a consequence of the reduction in administration costs.

109. Whether the relationship is inverse or direct is not, perhaps, so relevant, as an appreciation of the fact that the split between administration costs and compliance costs is not fixed. Costs can be shifted from the public sector to the private sector and back. Inevitably, the precise relationship will depend upon a host of factors, including relevant legislation, the type of tax and taxpayers involved, and other aspects of the political and economic culture.

110. Based upon the fact that the relationship is not fixed and may be inverse, if the political will exists and resources are available, the New Zealand Inland Revenue can take a heavier burden of dealing with the CGT in its earlier years, correspondingly lightening the tax compliance burden for taxpayers in those early years. For example, it could choose to provide a CGT computational website where taxpayers can upload factual details relating to their assets (such as quoted shares) and identify the CGT liability for the taxpayer to use in submitted returns.

111. Another obvious measure, given that it is a key driver of CGT compliance costs, is the provision by the Inland Revenue of assistance to taxpayers and their advisers with appropriate record keeping mechanisms. These may be digitized, electronic, manual or a combination and should relate to the key assets that taxpayers are likely to encounter that may lead to CGT consequences: principally real estate and quoted shares.

112. The Inland Revenue may also wish to consider whether it is in a position to mitigate tax compliance costs by providing assistance in the valuation of assets, another established driver of CGT compliance costs.

113. Given that CGT compliance costs are usually high, any further initiatives that can be taken by the New Zealand Inland Revenue to mitigate or minimize the impact of these costs will be welcome. The OECD has suggested that "compliance is most likely to be optimised when a revenue authority pursues a citizen-inclusive approach to compliance through policies that encourage dialogue and persuasion".[65] It would be expected in the introductory phase of a new tax like the CGT the focus of Inland Revenue attention would be on education and voluntary compliance as opposed to a sanctions-based approach; a cooperative and positive engagement with taxpayers and their advisers in a customer-service focused and user friendly environment will be more productive and efficient than adversarial and antagonistic approaches.

[65] OECD (2004), *Compliance Risk Management: Managing and Improving Tax Complianc*e. Paris: OECD, at p.48.

114. Hence a comprehensive on-line guide or series of guides to the CGT, written in lay terms and user-friendly to all taxpayers, will be an essential output from the Inland Revenue at an early stage in the introduction of the CGT.

115. Strategies designed to foster voluntary compliance have taken two broad and mutually supportive directions in most developed nations (and New Zealand is often at the forefront): building positive taxpayer and tax community morale; and making compliance easier and cheaper for taxpayers.

116. Enhanced taxpayer morale is likely to occur where fiscal ignorance is tackled and reduced, where taxpayers feel that they are getting a fair deal from the exchange relationship with the state, where the environment is cooperative and where positive attitudes towards taxation are nourished. Based upon this analysis, a carefully designed community awareness campaign (aimed at taxpayers, their advisers, industry associations and other community bodies) about the tax, who it affects and what they need to do would be the minimum expected from the Inland Revenue if a CGT is introduced.

117. Inland Revenue strategies that can help to make it easier and cheaper to comply include, fairly obviously, *consulting and collaborating on co-design* with taxpayers and the tax professional community; *making taxpayer obligations clear*; and *smoothing transactions and interactions* between taxpayers, their advisers and the Inland Revenue wherever possible.

118. *Consultation/collaboration and co-design* adequately summarises the importance of any revenue authority ensuring that it adopts an "empathetic, user-based approach [that] ensures administrative solutions are designed around what works for the community".[66] In order to make it easier and cheaper to comply, it is important that reporting, filing, record-keeping and payment processes for the new CGT work, so far as possible, in harmony with the ways in which taxpayers and their advisers operate. The benefits of consultation, collaboration and co-design will always far outweigh the costs involved.

119. The OECD has pointed out that "if taxpayers do not understand what their obligations are, any intervention to enforce compliance will be perceived as unfair".[67] It is therefore vital for the Inland Revenue to make taxpayers' obligations clear from the outset – in the sense of being transparent, easy to understand, simple and non-confusing.

120. The third group of strategies designed to make it easier and cheaper for taxpayers to comply with their tax obligations relates to the capacity of the revenue authority to provide convenient and inexpensive ways for taxpayers to interact with, or undertake transactions with, the revenue authority. Making it easy and inexpensive to comply can, potentially, include all the initiatives an authority such as the Inland Revenue might take to improve service delivery in relation to a newly introduced CGT.

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[66] Australian Taxation Office, *Compliance Program 2008-09*, Canberra: Commonwealth of Australia, at p 6.

[67] OECD (2004), *Compliance Risk Management: Managing and Improving Tax Complianc*e. Paris: OECD, at p.48.

VI. Conclusions And Recommendations

121. New Zealand enjoys an enviable reputation for the range and quality of many aspects of its tax policy process, legislative provisions and administrative systems. Much of the innovation is based upon its status as a "first mover" in tax (and other) matters. Ironically, it is a "last mover" so far as CGT is concerned, but that may not be such a bad thing. It certainly enables New Zealand to seek out world's best practice and also to learn from other countries' mistakes. South Africa — when it introduced its CGT in 2001 — clearly benefited from a careful analysis of the CGT issues and problems that beset countries like the UK (1965), Canada (1972) and Australia (1985) when they introduced their regimes. As such, its regime probably combines the best features of those other countries, customised for local conditions.[68]

122. This Report has explored the compliance cost implications that would arise if a CGT were to be introduced in New Zealand. It has considered the major trends, causes and drivers established by research into tax compliance costs and has determined that the impact of CGT compliance costs will not be insignificant on those taxpayers affected no matter what design features are adopted. However, it has also identified, based upon the experience of other countries, that certain of the design features of the proposed New Zealand CGT can either increase or decrease tax compliance costs and that other measures, not expressly covered in the TWG Interim Report, may also have an impact.

123. It must be stressed that the best compliance costs outcomes, either in relation to single design features or in relation to the CGT system as a whole, will not necessarily give rise to the best CGT or tax system outcome. Tax design and tax reform should take account of compliance costs (and it is gratefully acknowledged that New Zealand certainly leads the world in this respect), but it is only one of several often more important considerations or principles, including efficiency, equity and fairness, revenue integrity, fiscal adequacy, coherence predictability and certainty.[69]

124. The contents of this Report suggest a set of broad guidelines or high-level principles as to how CGT compliance costs may be mitigated or minimized if a CGT regime were to be introduced in New Zealand. More particularly, it suggests that in designing a CGT regime which will not impose relatively high CGT commencement and recurrent compliance costs:

- minimize legislative change. Attempt to get the design of the CGT right from the start. Avoid incremental change. Less frequent change and more consultative change will ensure that commencement costs are minimized and recurrent costs are not onerous;
- accept that a CGT may inevitably be complex but seek to minimize both statutory (technical and transactional) complexity and effective (or compliance) complexity. The former will be minimized where careful consideration is given to the necessity for each exemption, roll-over or other departure from the comprehensive base. The fewer the number of concessions or preferences, the lower the compliance costs.

[68] C Evans and R Krever (2017), "Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand", *New Zealand Journal of Tax Law and Policy* Vol 23, No 4, pp 486-515 at 509.
[69] Tax Working Group (2018), *Future of Tax: Interim Report*, Wellington: New Zealand Government, at p 12.

The latter will be minimized where the number of taxpayers affected by the tax, and the number of interactions with advisers and the revenue authority are kept to the minimum possible;

- minimize choice. Optionality in a CGT system causes compliance costs to increase as taxpayers engage in unnecessary or unprofitable tax planning; and
- be prepared to accept rough and ready outcomes rather than seeking the "perfect" or model CGT. It may not always be as fair as it could be, but it will always be simpler.

125. This Report concludes by listing below a series of recommendations (together with references to the paragraphs in which each of these recommendations is discussed) that the author of this Report believes will lead to the best possible compliance cost outcomes if a CGT is introduced in New Zealand.

List of recommendations:

1. The tax treatment of capital gains should be as closely aligned to the tax treatment of other income as possible in terms of rates of tax. Avoid either indexation of the cost base or exclusion of part of the gain by means of a CGT discount or similar. In this way it will be possible to minimize compliance costs by significantly reducing the costs of tax planning which would otherwise be undertaken to transform highly taxed income to preferentially taxed capital gains. (Paragraphs 60, 61 and 76.)

2. Minimize the number of exemptions from the comprehensive base, accepting that some will be necessary. (Paragraph 61.)

3. Accept the need for the exemption of the family home, but then be very wary of seeking to carve out exceptions to this exemption. For example, it will be potentially difficult (and compliance costly) to police a line between (non-exempt) mansions and other (exempt) family homes, particularly given the behavioural tax-induced responses that may ensue if such a distinction is drawn. (Paragraphs 62 to 64.)

4. Accept the need for the exemption of personal use assets. This will have the effect, as with the family home, of significantly reducing commencement and recurrent compliance costs that would otherwise have occurred if such assets were not exempted. (Paragraph 65.)

5. Assuming the cost of the revenue foregone is not an issue, accept that the exemption of personal use assets can extend to valuable collectibles. If lost revenue is an issue, then adopt an appropriate de minimis threshold for such items, with only valuable collectibles below this threshold entitled to be exempt. (Paragraph 66.)

6. Accept the proposal to exempt the disposal by New Zealand tax residents of certain homes outside New Zealand where the gain is taxed overseas or where a comparable overseas CGT regime applies. (Paragraph 68.)

7. Accept the proposal that the CGT regime should generally operate on a realization (as opposed to accruals) basis. (Paragraph 71.)

8. Minimize the number of roll-overs available, accepting that some will be necessary. The policy rationale for each roll-over needs to be carefully identified as each such deferral adds to both statutory and effective complexity and exacerbates CGT compliance costs. (Paragraphs 73 and 74.)

9. On transition to the CGT accept the valuation day approach to re-basing of assets, subject to the pragmatic modifications mentioned in the TWG Interim Report. Although the need for valuations will increase commencement compliance costs (and will also have some recurrent cost impact) this outcome is far more preferable than the alternative of the Australian grandfathering approach. It will avoid considerable statutory complexity and minimize recurrent compliance costs by significantly reducing the efforts expended in retaining the pre-CGT status of assets as time elapses. (Paragraphs 77 to 79.)

10. Re-consider the decision to adopt different loss offset rules for different classes of assets as this will lead to higher compliance costs than where capital losses are ring-fenced within the CGT regime. (Paragraph 80.)

11. Consider the introduction of a non-cumulative annual exempt amount (AEA) for personal and possibly certain trust taxpayers. This AEA (comprising a threshold figure between NZ1,000 and NZ$20,000 together with a capital proceeds test of double the threshold) would considerably reduce the number of taxpayers required to compute gains and submit returns each year, and hence considerably reduce CGT recurrent compliance costs (Paragraphs 85 to 97.)

12. Do not introduce special regimes for the SME sector on the basis of compliance cost considerations. If it is decided, on other grounds, to introduce special concessions for the SME sector, be very clear on the rationale for the concession (to enhance economic growth or to fund retirement?) and seek to minimize the compliance cost impact by clearly legislating the provision(s) in relation to definition, eligibility and consequences. Avoid the confusion and high compliance costs of the Australian CGT small business concessions. (Paragraphs 98 to 104.)

13. The New Zealand Inland Revenue should be encouraged to explicitly take up some of the compliance burden that would otherwise be incurred by taxpayers and their advisers in the early years of the CGT regime in order to mitigate (primarily) commencement compliance costs. For example, they could be resourced to provide specific web tools and apps to compute capital gains for taxpayers; to provide digitized, electronic and manual asset registers to assist record keeping; and possibly to provide assistance in valuation issues. (Paragraphs 105 to 112.)

14. The Inland Revenue can also greatly assist taxpayers to minimize CGT compliance costs by providing clear and concise guides to the CGT provisions which are user-friendly and written in plain English; and by planning and conducting a comprehensive,

consultative and collaborative community awareness campaign, if possible in advance of the commencement of the CGT regime. (Paragraphs 113 to 120.)

APPENDIX: AUSTRALIAN CGT SMALL BUSINESS CONCESSIONS

The Australian CGT small business relieving provisions are contained in Division 152 of the *Income Tax Assessment Act 1997*. If certain conditions are satisfied, then capital gains made by small business entities can be eliminated or reduced by one or more of the four CGT small business concessions that are available. Significantly there is no statutory limit to the amount of the capital gain that can be eligible for the concessions and thereby eliminated or reduced.

The four Australian CGT small business concessions are:

- the 15 year exemption. Under this concession a small business entity can disregard a capital gain arising from an active CGT asset that it has owned for at least 15 years;
- the small business 50 per cent active asset reduction. Under this concession the capital gain made by a small business entity is reduced by 50 per cent. This is in addition to the CGT general discount of 50 per cent, if applicable;
- the retirement exemption. Under this concession a small business entity can disregard up to AU$500,000 of a capital gain from a CGT event that has happened to any of its CGT assets; and
- the asset roll-over relief. This concession allows a small business entity to defer the making of a capital gain from a CGT event happening to one or more of its active CGT assets.

The concessions are broadly available to entities with net assets of no more than AU$6 million or who are CGT small business entities (entities who carry on business and have an annual turnover of less than AU$2 million), or partners in partnerships that are small business entities.

The rules apply on an aggregated basis, meaning the net assets or turnover taken into account is that of the taxpayer and of entities taken to be under the taxpayer's control known as "connected" entities and "affiliates". Broadly, entities are connected when one is 40 per cent owned by the other or where both are 40 per cent owned by a common entity. The affiliate rule is a subjective test that applies only to individuals or companies that act in concert with, or according to the directions or wishes of, another entity.