Tax Working Group
Te Awheawhe Tāke

Tax Working Group Information Release

Release Document

February 2019

taxworkinggroup.govt.nz/key-documents

This paper has been prepared by the Secretariat to the Tax Working Group for consideration by the Tax Working Group.

The advice represents the preliminary views of the Secretariat and does not necessarily represent the views of the whole Group or the Government.

Some papers contain draft suggested text for the Final Report. This text does not constitute the considered views of the Group. Please see the Final Report for the agreed position of the Group.

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

Certain information in this document has been withheld under one or more of the following sections of the Official Information Act, as applicable:

[1] 9(2)(a) - to protect the privacy of natural persons, including deceased people;
[2] 9(2)(f)(iv) - to maintain the current constitutional conventions protecting the confidentiality of advice tendered by ministers and officials;
[3] 9(2)(g)(i) - to maintain the effective conduct of public affairs through the free and frank expression of opinions;
[4] 9(2)(j) - to enable the Crown to negotiate without disadvantage or prejudice.

Where information has been withheld, a numbered reference to the applicable section of the Official Information Act has been made, as listed above. For example, a [1] appearing where information has been withheld in a release document refers to section 9(2)(a).

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

Coversheet: Loss ring-fencing

Position Paper for Session 23 of the Tax Working Group
22-23 November 2018

Purpose of discussion

This paper adds to the paper *Rollover treatment and Loss ring-fencing* (Decision Paper for Session 20 of the Tax Working Group). It outlines situations in which loss ring-fencing may be required, in light of the Group's decisions so far.

Key points for discussion

This paper discusses:

a. what loss ring-fencing is;
b. reasons for and against loss ring-fencing;
c. particular situations which may justify loss ring-fencing, namely:
   i. uncertain valuations
   ii. associated parties' transactions;
   iii. portfolio listed shares and derivatives and other similar assets;
   iv. rollover situations;
   v. exemption situations.

Recommended actions

We recommend that you:

a **agree** that capital losses should not generally be ring-fenced to capital gains

b **agree** that loss ring-fencing should apply to any asset which can be traded with low transaction costs and can be easily regained after crystallising a loss, but are not already taxed as a financial arrangement (including portfolio shares and derivatives)

c **agree** that integrity measures are required for the following situations:
   i. where the cost base or deemed sale price of an asset is determined using an uncertain valuation instead of actual cost;
   ii. losses on transfers between associated persons;
   iii. where taxpayers can choose to apply an exemption to a gain but not to a loss.

d **agree** that further consideration should be given to alternative integrity measures for the situations listed in c) above (in addition to loss ring-fencing) under the Generic Tax Policy Process

e **agree** that loss restriction should apply to small businesses that qualify for rollover relief

f **agree** that capital loss ring-fencing is not required for other rollover situations

Loss ring-fencing

Position Paper for Session 23
of the Tax Working Group

November 2018

Prepared by the Inland Revenue Department and the Treasury

TABLE OF CONTENTS

Executive Summary 5

1. Introduction 6

    1.1 Purpose 6

    1.2 Content and scope 6

2. General principles behind loss ring-fencing 7

    2.1 What is loss ring-fencing? 7

    2.2. Possible reasons for loss ring-fencing 7

    2.3 Trade-offs of loss ring-fencing 10

3. Situations that may require loss ring-fencing 13

    3.1 Integrity issues with valuation 13

    3.2 Integrity issues with timing 15

    3.3 Integrity issues with exemptions 17

    3.4 Secretariat recommendations 18

Executive Summary

When a loss is ring-fenced, it can only be offset against certain gains. Capital loss ring-fencing can be general (in that a capital loss may be offset against any capital gain) or specific (for example, a loss from a specific asset may only be offset against a gain from the same type of asset).

General ring-fencing is common when a lower tax rate applies to capital gains and losses than to ordinary income (and losses). Most countries that tax capital gains at flat or discounted rates tend to have general loss ring-fencing, but countries that include capital gains as ordinary income and tax at marginal tax tend not to.

Even where capital gains are taxed as ordinary income, loss ring-fencing rules might still be justified for fiscal or integrity reasons. However, loss ring-fencing can have negative impacts on fairness, simplicity and efficiency. The Secretariat does not consider that fiscal reasons in themselves justify general capital loss ring-fencing.

An integrity risk can arise if taxpayers can choose to defer tax on capital gains and bring forward capital losses. The Secretariat supports the Group's interim recommendation to ring-fence losses on portfolio listed shares and derivatives and suggests that it be extended to any asset where costs to trade are low, and economic exposure to the particular asset can easily be regained after crystallising the loss (and that is not already taxed as a financial arrangement). The Secretariat also recommends restricting losses for small businesses that qualify for rollover relief, as rollover means that the same integrity risk for timing arises (i.e. small businesses can rollover gains and bring forward losses).

There are other integrity issues that arise whenever tax losses are allowed. For example, issues arise with associated persons transactions, unreliable or concessional valuations, and situations where taxpayers can choose to apply an exemption to a gain but not a loss. However, loss ring-fencing is only one possible integrity measure. There is a range of different measures used by other countries, some of which are more targeted than loss ring-fencing. The Secretariat recommends that further consideration be given to alternative integrity measures.

1. Introduction

1.1 Purpose

1. The purpose of this paper is to provide the Group with further information and analysis to assist with the Group's decisions on loss ring-fencing, in light of the Group's decisions on rollover.

1.2 Content and scope

2. This paper discusses what loss ring-fencing rules may be required if capital gains are taxed more comprehensively. It does not discuss planned or existing loss ring-fencing rules, such as for rental losses or losses of an attributing controlled foreign company (*CFC*).

3. The first part of this paper discusses general principles behind loss ring-fencing. It explains what loss ring-fencing is, possible reasons for ring-fencing, and the trade-offs involved.

4. The second part of this paper discusses particular situations that may require loss ring-fencing and provides recommendations on whether or not there should be loss ring-fencing. The situations discussed include:

    a. Uncertain valuation situations
    b. Associated persons' transactions
    c. Portfolio listed shares and derivatives (and similar assets);
    d. Rollover situations; and
    e. Exemption situations that cause integrity issues.

2. General principles behind loss ring-fencing

2.1 What is loss ring-fencing?

5. Most countries with capital gains taxes ring-fence losses to some degree:

   a. Loss ring-fencing can be ***general***, in that capital losses can only be offset against capital gains (and not ordinary income, such as trading profits). General loss ring-fencing would preserve the existing capital/revenue distinction, and remove one of the key reasons for including capital gains as ordinary income and taxing them at ordinary marginal rates.

   b. Loss ring-fencing can also be ***specific***. For example, capital losses from certain asset classes may only be offset against gains from the same asset classes; or capital losses from sales to certain persons may only be offset against gains from sales to the same person (see below at paragraph 29).

6. Loss ring-fencing is often proposed as a potential integrity measure as it limits the extent to which taxpayers may use losses. However, loss ring-fencing is only one of several possible integrity measures and is a relatively 'blunt' measure. Other potential measures are discussed below and may be more targeted and/or appropriate than loss ring-fencing in different circumstances.

2.2. Possible reasons for loss ring-fencing

7. In theory, a neutral tax system should have symmetrical treatment for gains and losses: where a gain is taxable, a loss should be deductible at the same rate.[1]

8. Countries that tax capital gains at a flat or discounted rate (compared to ordinary income) include Australia, Canada, the United Kingdom and the United States. None of these countries allow capital losses generally[2] to be offset against ordinary income (unused losses can be carried forward, or sometimes carried back, subject to shareholder continuity requirements for companies).[3] In contrast, revenue/ ordinary losses are not typically ring-fenced and may be used to offset capital gains that are taxed at a lower rate.

9. Countries that generally[4] tax capital gains at the same rates as ordinary income include Mexico, Norway and Switzerland. None of these countries have general

---

[1] If the tax treatment were entirely symmetrical, net losses should in theory be refundable. However, this is not desirable from a revenue adequacy perspective and is likely to increase integrity risks.

[2] There are limited exceptions – e.g. the United States allows capital losses of up to $3,000 per year to be offset against ordinary income and the Canada and the United Kingdom have limited relief for certain small to medium businesses.

[3] It is not clear that, say, a 50% inclusion rate necessitates loss ring-fencing. It might, for example, be possible to allow 50% of losses to be offset against any form of income.

[4] Note that some of these countries tax shares at lower rates and/or have participation exemptions which mean that some share gains are exempt if certain conditions are met. To achieve symmetry, countries tend to deny losses on shares that qualify for such exemptions. There can also be special rules for real property – for example, these are taxed in Switzerland at a local level.

loss ring-fencing.[5] For corporates (but not individuals), Australia, Italy, Germany and the United States also tax capital gains at the same rates as ordinary income. Germany and Italy ring-fence shares held at the individual level but not the corporate level. Australia and the United States ringfence all capital losses of companies even though the gains are taxed at ordinary rates. We note, however that different tax treatment for corporates and individuals may mean there is less risk from allowing losses at the corporate level; with imputation this risk may be bigger.

Table 1: Summary of ring-fencing rules

Country	Australia	Canada	UK	US	Mexico	Norway	Switzerland
Capital gains generally taxed at flat or discounted rate?	Yes (individuals)	Yes	Yes	Yes (individuals)	No	No	No
General loss ring-fencing?	Yes	Yes	Yes	Yes	No	No	No

10. Specific loss ring-fencing for certain asset classes may be justified if there is a risk that taxpayers may characterise these assets as business assets and claim losses even though, in reality, the assets are expected to be loss-making and represent a form of private consumption.[6] For example, Australia and Canada ring-fence losses from art and collectables. As the Group does not propose to tax capital gains from assets that are likely to represent private consumption more comprehensively (e.g. art, collectables, jewellery) and proposes to deny losses on property held for private purposes (e.g. baches) entirely, this paper will not discuss ring-fencing these asset categories.

Integrity reasons for ring-fencing

11. In practice, integrity issues may arise that could justify some form of restriction on losses. These integrity issues could mean that loss ring-fencing would make the tax system *more* symmetrical, rather than *less*.

12. The next Chapter discusses integrity issues with valuation, timing and exemptions:

    a. **Valuation**. If the cost base or the realisation value of an asset is not reliable, restrictions on losses may be desirable to guard against inflated or deflated valuations. For example, parents could buy a rental property and sell it to their children for below market value (say, at its RV) and claim a tax loss on the sale. Although this would be an associated persons transaction and should be deemed to occur at market value, loss ring-fencing would buttress

[5] Mexico taxes shares at a lower flat rate and has restrictions on losses on shares, but capital gains and losses are otherwise treated as ordinary income or losses.

[6] See OECD Tax Policy Studies (2006) *Taxation of Capital Gains of Individuals: Policy Considerations and Approaches* (No 14) at p 17.

the associated persons rules by ensuring the loss could not be offset against ordinary income. However, general loss ring-fencing would not completely solve this issue as the loss may still be used, but only against certain gains.

b. **Timing**. A realisation-based tax on capital gains means that gains and losses are only taxed when there is a realisation event that does not qualify for rollover. In some situations, taxpayers have a greater ability to 'cherry-pick' by bringing forward taxable losses and deferring taxable gains. Such situations may be where rollover is within the taxpayer's control (either because the taxpayer can control the trigger event or the decision to apply rollover), or where assets are fungible and readily tradeable (e.g. listed shares). Again, ring-fencing does not completely solve this issue as a taxpayer with existing capital gains would still have an incentive to bring forward any capital losses (and defer realising further capital gains).

c. **Exemptions**. Integrity concerns with exemptions may arise if taxpayers can choose to apply an exemption to a gain but not to a loss.

13. It should be remembered that loss ring-fencing is merely one type of restriction on losses (and may not necessarily resolve the integrity issue in question). Other possible restrictions include compulsory rollover for losses or loss denial for avoidance transactions (these are discussed in the next Chapter).

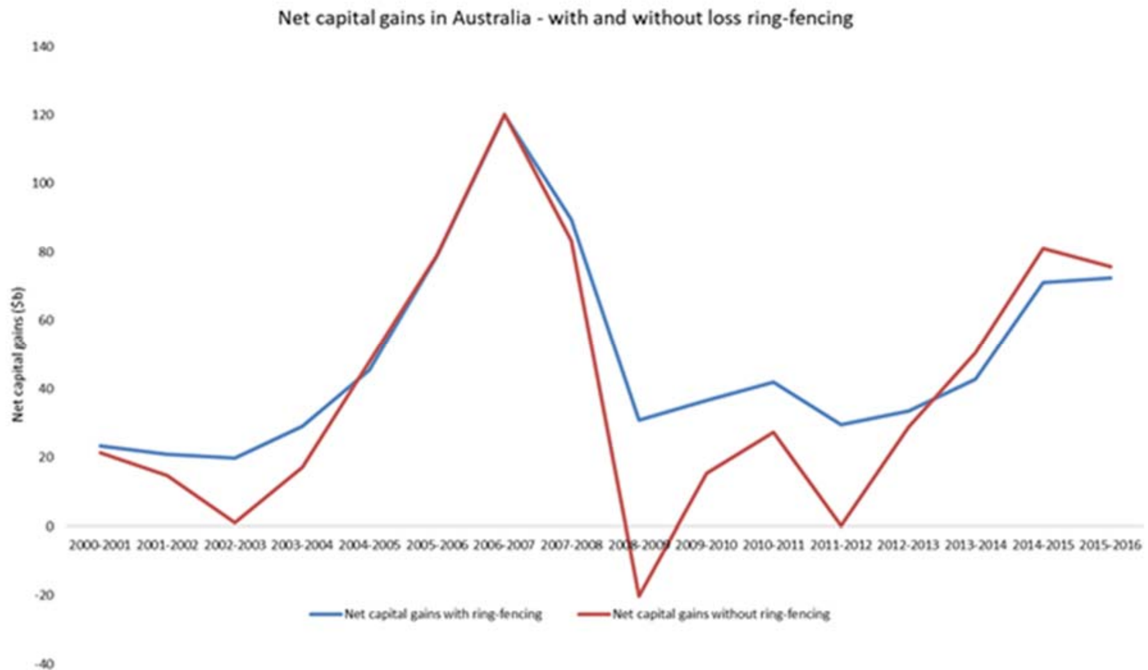
Fiscal reason for loss ring-fencing

14. Another possible reason for loss ring-fencing is to protect government tax revenue in a downturn. However, taxing more capital gains is countercyclical from a macroeconomic stability perspective, and this is generally considered a benefit in terms of supporting economic stability (enhancing the automatic stabilisers). In practice, this requires disciplined fiscal management to ensure that government spending does not rise unsustainably when there is an asset price boom that increases revenues temporarily.

15. Perhaps more importantly, ring-fencing would reduce the neutrality of taxing capital gains if capital losses cannot be used during downturns (when losses are most likely to occur). For these reasons, the Secretariat does not consider fiscal reasons in themselves are sufficient to justify capital loss ring-fencing.

16. It is difficult to model the fiscal impact of loss ring-fencing, as the impact is greatest during a downturn and therefore the fiscal impact would depend on the timing and extent of any future downturns. However, the following chart shows what impact loss ring-fencing would have had on the net taxable capital gains in Australia from 2000 to 2016, assuming no behavioural change.

Figure 1: Impact of loss ring-fencing in Australia on net capital gains, 2000 to 2016[7]



Source: Australian Taxation Office, Taxation Statistics with subsequent Secretariat calculations. The data in this graph uses the best information available to the Secretariat in the time available and is subject to further quality assurance.

17. As the graph above shows, loss ring-fencing increased net capital gains in the periods following financial crashes from 2000 to 2004 and 2007 to 2012. It had almost no net fiscal impact in the period from 2004 to 2007.

2.3 Trade-offs of loss ring-fencing

18. As explained above, loss ring-fencing can help mitigate tax integrity concerns created by some taxpayers taking advantage of opportunities to inflate or bring forward tax losses and defer or reduce taxable gains. There is also a fiscal benefit to ring-fencing (particularly in or following an economic downturn).

19. However, loss ring-fencing should not be considered in isolation. Full inclusion of capital gains at ordinary rates, limited rollover, and limited loss ring-fencing, has simplicity, compliance cost, fairness, and efficiency benefits. Broad loss ring-fencing rules would remove some of these benefits:

    a. **Simplicity**. Loss ring-fencing rules create boundary issues and therefore increase complexity and compliance costs. General loss ring-fencing would

[7] The data only includes individuals, superannuation funds and companies. It does not include trusts directly due to data limitations (but some would be included indirectly in individuals' data).

maintain the capital-revenue boundary and remove some of the key benefits from taxing capital gains as ordinary income at marginal rates. For example, taxpayers would still have an incentive to try to classify losses as revenue losses and to classify gains as capital gains (to use them against ring-fenced capital losses). More specific loss ring-fencing based on some other criterion (e.g. to gains of the same asset type), would create further boundary issues. See also the papers by the Secretariat[8] and Professor Chris Evans[9] on compliance costs.

b. **Fairness**. Loss ring-fencing rules reduce horizontal and vertical equity and can also impact public perceptions of fairness:

   i. *Horizontal equity*. Although loss ring-fencing is aimed at taxpayers who take advantage of tax minimising opportunities, they inevitably apply also to investors with genuine capital losses and reduces the value of those losses (compared to ordinary losses that may be used to offset any income). One of the Australian practitioners we consulted with advised that, in practice, large corporates viewed capital losses (which are ring-fenced in Australia) as having virtually no value. Loss ring-fencing is therefore a relatively "blunt" tool in that it may be aimed at taxpayers who engage in aggressive tax planning, but apply generally to all taxpayers.

   ii. *Vertical equity*. Loss ring-fencing can also reduce vertical equity as capital gains and losses are, by their nature, relatively rare. Taxpayers with larger and more diversified portfolios, who also tend to be wealthier, will therefore be more likely to be able to use ring-fenced capital losses.

   iii. *Public perceptions of fairness*. One Australian practitioner said that it was difficult explaining to ordinary taxpayers why their gains are taxed but their losses cannot be used and suggested limiting loss ring-fencing to the extent possible. Another Australian practitioner explained how the 1987 stockmarket crash caused Australia to loosen their ring-fencing rules.[10]

c. **Efficiency**. Because loss ring-fencing reduces the symmetry in tax treatment of capital gains and losses by reducing the value of capital losses, it creates a bias against risky investments that may generate capital gains or losses. This tax bias can discourage investment in some activities with high expected returns that would have been attractive with tax settings that treat risk more

---

8 *Compliance costs of taxing more capital gains* (Position Paper for Session 23 of the Tax Working Group, 22-23 November).

9 Professor Chris Evans *The Compliance costs of Taxing Capital Gains* (13 November 2018).

10 Taxpayers made large 'revenue' gains for shares sold in the first half of the year as they were sold within 12 months. However, when they sold their shares at a loss in the second half of the year the losses were realised after 12 months so were treated as 'capital' losses and could not be used to offset their revenue gains.

neutrally (see Example 1). At the margin, this will tend to reduce the productivity of investments in New Zealand.

Example 1 – Safe vs risky investment
An investor has the choice of investing $100 in two different ways: • Option A: Fixed return of $5 in a year's time • Option B: 50% chance of a $30 capital gain and a 50% chance of $10 capital loss in a year's time Option B is more risky but has a higher expected value or average return of $10 (being 0.5*30 – 0.5*10). In the absence of tax, the investor might choose Option B if they judged the extra return worth the risk. However if losses are ring-fenced, the tax system may make Option A more attractive if the taxpayer is unable to use the losses to offset tax on their other income (the losses become harder to use and therefore less valuable).

20. Because of these disadvantages, some countries (including Canada[11] and the United Kingdom[12]) allow limited relief aimed at investments in small and medium businesses (the United Kingdom's relief is more restrictive – for example, it requires shares to have been in a company that engages in a qualifying trade). The United States allows individuals to offset capital losses of up to $3,000 against ordinary their ordinary income each year.[13]

21. The next Chapter discusses particular situations that may justify ring-fencing. These will be discussed in light of the above trade-offs.

---

[11] Canada Revenue Agency *Income Tax Folio S4-F8-C1, Business Investment Losses*.

[12] HMRC *HS286 Negligible value claims and Income Tax losses on disposals of shares you have subscribed for in qualifying trading companies* (6 April 2018).

[13] IRC 26 U.S. Code § 1211 (Limitation on capital losses).

3. Situations that may require loss ring-fencing

22. This Chapter discusses the types of situations that cause integrity issues with valuation, timing or exemptions, and may justify loss ring-fencing. It should be noted that some transactions pose integrity issues with more than one of these factors (e.g. associated parties' transactions pose issues with both valuation and timing).

3.1 Integrity issues with valuation

Uncertain valuations

23. As some taxable assets will transition into the tax base at market value (e.g. assets owned before the tax applies on Valuation Day, excluded homes that start being used for income purposes, or assets brought into the base on migration) many 'market values' will be needed, sometimes for assets that are difficult to value.

24. To mitigate compliance costs on taxpayers, most taxpayers will not need be required to obtain an independent valuation and Inland Revenue will produce guidance and 'rules of thumb' on what values would be acceptable. It is expected that some of these 'rules of thumb' may be quite generous or concessionary, in the sense that the taxpayer may choose between a number of options and select the one that produces the highest cost base.

25. Accordingly, an excessively generous 'rule of thumb' valuation could give a taxpayer such a high cost base that they realise a 'paper loss' when they have made an actual gain. For assets that transition into the tax base on Valuation Day, the issue is resolved by the median rule which effectively denies paper losses. However, the median rule cannot apply on migration because of treaty issues. It could also cause difficulties where assets move in and out of the base several times (e.g. if an excluded home becomes rented out, and the owners move back in again).

26. For such other (non-Valuation Day) transitions, the Secretariat recommends further consideration under the Generic Tax Policy Process of whether loss ring-fencing, or another integrity measure such as the median rule, should apply if the cost base or deemed sale price is determined using an uncertain valuation.

Associated parties' transactions

27. Associated parties' transactions pose integrity issues with valuation because the pricing tension that would ordinarily produce an arm's length price between unrelated parties does not exist. As a result, tax rules ordinarily deem transactions between associated parties to be at market value.

28. Associated parties' transactions also pose integrity issues with timing. Even where a capital asset has genuinely declined in value, an integrity risk arises if taxpayers could simply sell depreciated assets for market value to an associated party to

crystallise a tax loss (without having genuinely parted with the ownership of the asset).

29. Because of these integrity issues, most countries have rules that restrict losses on transfers between associated parties. Not all of these rules take the form of loss ring-fencing.

    a. Australia does not have specific provisions dealing with losses between associated parties. The Australian Tax Office (*ATO*) considers "wash sales", whereby a taxpayer sells an asset to crystallise a tax loss but has not truly parted with the economic ownership of the asset, can fall under their general anti-avoidance rules. The ATO's examples of wash sales include transfers to related parties in a variety of different fact situations.[14] In the Secretariat's view, general anti-avoidance rules are not the best option for dealing with these types of systemic problems, as the application of the rule can be uncertain, costly to enforce, and comes with litigation risk.

    b. In South Africa[15] and the United Kingdom,[16] capital losses from transfers between associated parties[17] are ring-fenced or 'clogged' so that they can only be offset against capital gains arising from transfers to that same associated party (at a time while the parties are still associated). This rule can be quite harsh and may result in clogged losses becoming practically unusable. Difficulties can arise if an associated party relationship is broken after a clogged loss (e.g. a divorce, or a company exiting a group), which can lead to the loss never being able to be used.

    c. The United States effectively rolls over losses on transfers between associated parties (the transferor's loss is denied but the transferee can use the tax loss to offset a subsequent gain, subject to certain restrictions).[18] A disadvantage of this approach is that it could allow taxpayers to rollover losses from a taxpayer on a lower tax rate to a taxpayer on a higher tax rate.

    d. In Canada, a loss from the transfer of property is treated as a "superficial loss" if: [19]

---

[14] See TR 2008/1 *Income tax: application of Part IVA of the Income Tax Assessment Act 1936 to 'wash sale' arrangements* https://www.ato.gov.au/law/view/pdf/pbr/tr2008-001.pdf.

[15] http://www.sars.gov.za/TaxTypes/CGT/Proceeds/Pages/default.aspx

[16] Taxation of Chargeable Gains Act 1992, s 18(3); see also https://www.gov.uk/hmrc-internal-manuals/capital-gains-manual/cg14561.

[17] This can also include parties that become associated a result of the transfer – e.g. in an asset for share swap.

[18] See 26 U.S. Code § 267; see also IRS *Sales and Other Dispositions of Assets* (2018) https://www.irs.gov/pub/irs-pdf/p544.pdf at 23-24.

[19] https://www.canada.ca/en/revenue-agency/services/forms-publications/publications/t4037/capital-gains-2016.html#P3498_137482

i. the transferor or their associate buys, or has the right to buy, the same or identical property ("the substituted property") 30 days before or after the sale; and
ii. the transferor or their associate owns, or has a right to buy, the substituted property 30 days after the sale.

A superficial loss cannot be offset against income but is effectively rolled over to the person who acquires the substituted property as it can be added to the adjusted cost base of the property. As in the United States, this approach can allow losses to be rolled over from a taxpayer on a lower tax rate to a taxpayer on a higher tax rate.

30. The Secretariat recommends that there should be an integrity measure applying to losses resulting from transfers to an associated party. As shown above, a variety of different integrity measures are possible, and it is not clear which measure is the best. The form and design of such measures would benefit from further consideration and, in the Secretariat' view, is not central to taxing capital gains more comprehensively. The Secretariat recommends that the form and design of those rules should be determined under the Generic Tax Policy Process.

3.2 Integrity issues with timing

Portfolio listed shares and derivatives (that are not already treated as financial arrangements)

31. As explained in Appendix B of the Interim Report (at paragraphs 101–102 and 104):

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

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

32. The Group therefore made the interim recommendation to apply loss ring-fencing to portfolio listed shares and derivatives that are not already treated as financial arrangements, with losses only allowed to be offset against capital gains and dividends from such assets.

33. The Secretariat supports that decision but recommends that it be extended to any asset where costs to trade are low, and economic exposure to the particular asset can easily be regained after crystallising the loss (but are not taxed as financial arrangements). For example, this may include precious metals or cryptocurrencies.

Rollover situations

34. As discussed in the *Rollover treatment and Loss ring-fencing* paper,[20] rollover is an opportunity for taxpayers to defer gains. Even where rollover is mandatory, taxpayers may be able to choose not to rollover losses by ensuring that they do not meet the requirements of rollover. For example, if rollover for insurance proceeds of a destroyed asset requires that a similar replacement asset is purchased within a specific timeframe, the taxpayer could purchase a dissimilar asset or purchase a replacement asset outside the required timeframe.

35. The integrity risk is greater if the realisation event itself is also in the taxpayer's control (e.g. in gifts or voluntary sales), and if the transfer is to an associated party. (As discussed above, associated parties' transactions cause integrity risks apart from rollover but can be restricted in ways other than loss ring-fencing.)

36. However, as explained in Chapter 2, drawbacks to loss ring-fencing include negative impacts on simplicity, fairness and efficiency. In some cases, an integrity risk may exist but will not be sufficiently high to justify loss ring-fencing, or may be appropriately addressed with a more targeted measure.

37. The following table sets out the Secretariat's recommendations on loss ring-fencing for each of the situations in which the Group is recommending rollover, or suggesting rollover as an option:

Type of rollover situation	Secretariat recommendation on loss ring-fencing
Business reorganisations with no change in ownership in substance and no consideration	**May be required if losses between associated parties are not subject to another restriction** This is an associated parties' transaction and trigger events are within the taxpayer's control.

[20] *Rollover treatment and Loss ring-fencing* (Decision Paper for Session 20 of the Tax Working Group).

Certain involuntary disposals (e.g. compulsory acquisition and natural disasters)	**Not required**. Although rollover is effectively optional, the trigger event is relatively rare and not in the taxpayer's control. The Secretariat considers that the integrity risk is not high enough to justify loss ring-fencing.
Small business (< $5m turnover) – voluntary sale with reinvestment	**Required** Rollover is optional and the trigger event is in the taxpayer's control. There is no reason in principle to allow small businesses to claim unrestricted capital losses while they are not being taxed on their capital gains. In fact, disallowance of losses may be required if the small business concession does not require rollover into a similar asset.[21] We also note that, based on 2017 data,[22] over 95% of businesses in New Zealand could potentially qualify for the small business rollover and businesses with between $1m to $5m turnover had average fixed assets of $1.67m. The integrity risk of taxpayers cherry-picking losses therefore should not be disregarded. The Secretariat does note that loss ring-fencing would add compliance costs for small businesses. However, these costs would be required anyway to determine whether a taxpayer qualifies for the small business rollover.
Transfers on death (either for all assets or certain illiquid assets)	**Not applicable provided rollover is mandatory**
Gifting (for spouses/partners and suggested as an option more widely)	**May be required if losses between associated parties are not subject to another restriction** This is an associated parties' transaction and trigger events are within the taxpayer's control. Rollover may also be optional if partial gifts/transfers at undervalue are not rolled over.
Relationship property divisions and settlements	**Not required provided rollover is mandatory** However, as noted above, losses between associated parties *outside* of relationship property settlements should be subject to some integrity measure.

3.3 Integrity issues with exemptions

[21] If the small business rollover rule applies if reinvestment is made in any business asset (not just like-kind), then it could operate effectively as an exemption for capital gains, so disallowance of capital losses may be appropriate.

[22] Statistics New Zealand, Annual Enterprise Survey 2017 Financial Year.

38. Integrity concerns with exemptions may arise if taxpayers can choose to apply an exemption to a gain but not to a loss.

39. For example, because of restrictions in double tax treaties, non-residents generally[23] will not be subject to tax in New Zealand on the sale of shares in New Zealand companies. If capital losses were not ring-fenced, a company largely owned by non-residents could use capital losses to offset its ordinary income, but split off any assets with unrealised capital gains into a separate company in a de-merger. The de-merger would qualify for rollover relief if the new company is owned directly by the same shareholders as the original company's, in the same proportions. The non-resident shareholders could then individually sell off their shares in the new company and capital gains on the sale of those shares likely would not be taxed in New Zealand.[24] Effectively, the company would have recognised capital losses at the corporate level, and capital gains at the (non-resident) shareholder level. We note that there may be other examples of optional exemptions that, if applied asymmetrically, could also cause integrity issues.

40. General capital loss ring-fencing would increase symmetry in this situation by ensuring that the company could not offset capital losses against its ordinary income. However, the Secretariat's view is that general loss ring-fencing is blunt, as it would adversely impact New Zealand taxpayers with genuine capital losses. Instead, there may be more targeted ways of addressing the mischief described above such as, restricting capital losses for companies over a certain size that are largely owned by non-residents. This is something that may be considered under the Generic Tax Policy Process.

41. In principle, the Secretariat recommends some form of integrity measure to restrict losses in situations where taxpayers can choose to apply an exemption (including through a rollover that will never subsequently be realised in a way that is taxable and operates effectively like an exemption) to a gain but not to a loss. The Secretariat recommends that the form and design of those rules should be determined under the Generic Tax Policy Process.

3.4 Secretariat recommendations

42. The Secretariat does not recommend general capital loss ring-fencing.

43. The Secretariat supports the Group's interim recommendation to ring-fence losses from portfolio listed shares and derivatives and recommends that it be extended to any asset where costs to trade are low, and economic exposure to the particular asset can easily be regained after crystallising the loss (but are not already taxed as financial arrangements).

---

[23] Some exceptions apply to shares in land-rich companies.

[24] Unless the value of the shares was mostly attributable to New Zealand land and the relevant tax treaty gave New Zealand the right to tax those shares.

44. The Secretariat recommends some form of loss restriction for small businesses that qualify for rollover relief.

45. The Secretariat considers that integrity measures are required for the following situations, but recommends further consideration be given to other measures that are more targeted than loss ring-fencing:

    a. if the cost base or deemed sale price of an asset is determined using an uncertain valuation (recommend consider median rule if possible);
    b. losses on transfers between associated persons (recommend consider compulsory rollover, clogged loss, or specific anti-avoidance rules); and
    c. where taxpayers can choose to apply an exemption to a gain but not to a loss, such as by recognising capital losses at the corporate level but capital gains at the (non-resident) shareholder level.