Tax Working Group
Te Awheawhe Tāke

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November 15, 2018

Tax Working Group – Reform Options

Background

Since the release of the Interim Report, private sector feedback has raised two central concerns with the Report suggestions regarding the practical implementation of any proposed CGT.

These are:

- **Process concerns**. There has been strong feedback that there is inadequate time to develop a fully designed more comprehensive tax on capital gains, have ministerial consideration and decisions on that, draft a discussion document based on that, have GTPP consultation on that , consider and reach a final government view, draft legislation, proceed through full parliamentary process (including select committee hearings and consideration), with final enactment by July 2020 with the new legislative rules to take effect 1 April 2021 (possibly to apply from non-standard income years beginning 1 October 2020). I at least always envisaged TWG would in its final report set out a fully designed and developed a set of rules for a more comprehensive tax on capital gains. Now clearly this is not going to be the case. There are a number of key policy choices that we shall leave open for determination and a number of areas that we as a Group will not be able to analyse. I also note that GTPP processes (consultation, DD, bill) were designed mainly for technical reforms not major changes to the tax system. For major changes, the normal GTPP process tends to overwhelm private sector specialists and exclude others. For major changes, consideration should be given to a green paper (detailed reform proposals), white paper (final detailed proposals) with dedicated private sector input at each stage. In effect, TWG is drafting a green paper for its final report.
- **Transition and valuation date issues.** A key proposal in the Interim Report was that property that would become subject to tax on realisation would need to be valued as at the date the new tax rules come into effect. Feedback has been that this seems a practical hurdle. They are 534,000 enterprises in New Zealand (Statistics). Most of these would require an enterprise valuation and separately their assets would need to be valued. Also all land. Australian practitioners have emphasised that a key issue in valuation is identifying what to value. There can be business assets that are later sold but are not currently identified or seen as assets at all. Australian commentators have suggested that there would not be enough valuers in Australia to undertake this task let alone New Zealand.

Admittedly short cuts in process could be used and valuations short of those provided by qualified valuers used. However, what is clear is that these issues are causing widespread concern and that there are costs and risks of attempting to implement TWG proposals in accordance with the given timetable. The risks are not only poor legislation but a significant fiscal risk if high valuations result in large deductible losses. Rather than adding to revenue, the new tax rules could materially undermine the existing tax base. The median rule has been suggested as a safeguard but it seems to be able to be manoeuvred around and has its own problems (Australian advice has emphasized the difficulty in determining original cost price especially for inherited property (and does such property have a cost price?). The private sector has also raised concerns about the potential impact on New Zealand's already thin and somewhat fragile capital markets.

A less than robust policy development process could thus have material costs. On the other hand, there is a strong government commitment made in the last election campaign to adhere to the timetable set.

The following is an attempt to provide the government with some options that might, at least partially, meet some of the above risks and concerns as well as the timetable commitment. There is of course also the option of just deferring the timetable totally but this is not explored here.

This is not presented as an alternative design of a more comprehensive tax on capital gains that TWG is working on. It does not go into detailed design issues such as options regarding roll-over relief. It is assumed that the Final Report will set out a preferred design of such a tax. Presented below is a menu that Ministers can consider if the full comprehensive tax design is seen as not easily manageable within the stated timeframe.

The Approach

The basis of the Group's consideration of capital gains taxation has been that New Zealand already taxes many types of capital gains already and reform involves extending those rules. The view adopted in the Interim Report is that that a relatively comprehensive approach to an extension should be adopted – hence the issues of process and transition noted above. It would still be consistent with the extension approach to adopt a less ambitious agenda in terms of what is taxed and/or timing. To explore the options here various property categories are identified. The government could limit extension to one or a selection of those and/or phase the timing of bringing different property types into the tax base.

The Submissions Paper and in the Interim Report identified the following property types:

- Residential rental
- Residential non-rental (holiday homes)
- Commercial/industrial property (land and buildings)
- Farms and agricultural land
- Business assets
- Shares/equity
- Specialist property such as livestock

This is presented below as a menu of property that could be taxed more broadly listed on a broad assessment of what seems least complex/difficult to manage to the most complex. Complexity is a mix of initial transition issues, ongoing compliance costs, detailed rule design issues, and political management issues. The government could stop at any stage or select any number of property types. It can then look at staging the implementation of any tax. Considered first is the selection of property types to tax and then the staging of implementation of tax.

Residential Rental Property

Taxing residential rental property brings in the most revenue in the long term (officials' estimates – 35% to 40% of the total tax from extending tax on capital gains). It seems the easiest category to tax since in effect it basically applies the current law (dealer, develop, builder, brightline test) more generally. Rules need to be developed around definition and mixed-use/change in use although these have received a reasonably degree of consideration already by the Group including in the Interim Report.

Valuation rules do not seem so problematic in this area. There is the fall-back option of using RVs. This could be, at the option of the taxpayer, the last or next RV on implementation date provided the property is not sold before the next RV date. This would allow the property owner to make use of RV objection processes (although a higher RV means higher rates).

There seems no obvious reason why such property could not be more comprehensively taxed from 1 April 2021.

In addition, advice provided to TWG suggests that this is the most justified form of investment to tax. Officials have advised that subjecting residential rental to tax on a Fair Return Rate of 3.5% pa would raise almost $1 billion per annum of revenue additional to what is now taxed. It is hard to see how current tax rules that levy tax on this type of investment on the basis that it makes a less than 3.5% commercial annual rate of return can be seen as easily justified.

Taxing residential rental on a realised gain basis would not provide much additional revenue in the early years (officials' estimate $330 million in Year 3) but as noted above using Fair Return Rate of 3.5% would bring in almost $1 billion revenue from Year 1 if early revenue is an issue. Of course, the revenue streams are significantly different with realised gains forecast over time to be greater but having higher volatility.

Residential Non-Rental (holiday homes)

Residential non-rental property seems to raise similar issues to residential rental (similar valuation issues) but the compliance issues seem more complex. Whereas residential rentals are already in the tax base with return filing requirements and presumably at least rudimentary financial accounts that will generally not be the case with residential non-rental. They would need to keep accounts of cost base including distinguishing between capital costs (added to cost base) and revenue costs (not added to cost base).

The issues here also seem more difficult to manage in terms of public acceptance (the family bach/crib argument) requiring issues over roll-over relief to be determined.

Commercial/Industrial Land and Buildings

Commercial/industrial land and buildings raise more complex initial valuation issues. The existence of and terms of leases can be material in valuing the property and thus RVs are even less reliable. Moreover, this form of property is often integrated with general business assets (power generators).

Bringing commercial/industrial property into the tax base raises most of the complex design issues associated with business assets (roll-over relief). This is the area raising the process concerns noted at the outset.

It would thus seem appropriate to consider commercial/industrial land and buildings in the same context as business assets.

Farms and Agricultural Land (including forest land)

Again farms and agricultural land raises initial valuation issues that seem problematic. Taxing this form of property raises complex design issues (roll-over relief etc.) that give rise to process concerns. This form of property also more specifically raises iwi issues that seem to yet to be resolved in finality.

Business Assets

The design and valuation issues seem most difficult with business assets. Transition/valuation concerns seem most focused on valuing the closely held businesses although concerns are not just limited to this class of property. Many of the issues the Group has been unable to consider fully relate to business assets (the sale of a going concern and goodwill).

As Australian advisers have noted many of the difficulties with Australian CGT involve defining what the asset is that is being valued. The Group decided not to adopt the all-encompassing Australian approach to defining a CGT asset but it seems possible we would end up with the same result via an all-inclusive vague definition of “intangibles” and “goodwill”.

Australia over the last 30 years has developed value shifting, amalgamation, de-merger and script for script rules that we have been advised are necessary to the operation of these rules. The Group has not considered these to any material extent to date. Australian advice seems to be that a consequence of such rules (while making CGT work without seriously distorting investment decisions) is that large corporates seldom pay capital gains tax. They either do not sell assets increasing in profitability (making gains) or make sure they meet de-merger rule exemptions. The point was made that no Australian auditor would agree to include carry forward CGT losses as a deferred tax asset because of the very unlikely possibility of any taxable gain to use it against.

One has to wonder at the wisdom of developing complex rules with widely recognised high compliance costs in the case of business assets but no revenue. If we have no loss ringfencing, then that would be a loss in revenue. It would seem prudent to consider this issue more. A response may be not to have the Australian exemptions. Presumably, that would lead NZ companies to establish residence in Australia to get those exemptions (they would still be able to use imputation credits).

Consideration could be given to considering separately depreciable assets. These are already costed (valued) for tax purposes. Current rules tax depreciable property on gains (over book value) up to the amount of depreciation claimed (depreciation claw back). It would seem a mere extension of such rules to tax all the gains. In most cases, such gains will be limited although depreciable property includes for example software.

With respect to commercial and industrial property consideration could be given to (perhaps through election) linking depreciation/seismic cost deductions etc. to those assets that are held on revenue account. Thus no depreciation if the building is not also on revenue account.

These are new proposals which, if advanced, would seem to require more time for consultation.

Domestic Equity/shares

The taxation of equity/shares is very much linked with the taxation of business assets. Property can be transferred as either a business asset or as shares in a company owning a business asset.

According to officials' estimates shares make most of the revenue in the early years – 55% in Year 1 but only about 20% in the tenth year.

Valuation issues with non-listed companies are generally recognized as very problematic. While listed shares may be viewed as having clear values this is so only for marginal transfers. The listed share price is not the value of a substantial holding which can be more or less than the listed price. For example, the crown holding in Air NZ is not valued in the public accounts as the listed share price. Auditors would probably not agree if they were.

Bringing shares into the tax base raises all the issues with de-merger rules etc., noted above and the double deduction rules the Group has spent very limited time on.

I remain concerned regarding the double taxation of shares on unrealized company gains. This is a tax penalty on New Zealanders who own shares in New Zealand companies – an odd policy. The Canadian Carter Commission 1966 considered this to be a significant issue with capital gains tax. The Interim Report noted the issue. Officials' advice has been that if specific transactions are undertaken in specific timeframes then the issue may be mitigated – that does not satisfy me.

The risks here seem very material. If we tax penalise New Zealanders owning New Zealand shares and we have different tax rules for PIEs versus individuals we can easily significant damage the already thin and fragile New Zealand capital market. This requires more careful consideration than our timetable allows.

Australia seems to deal with the double tax issue by having rules that mean all tax on gains is attributed to the shareholder level and no tax at the company level. If that is the solution then it

seems logical to make this clearer – do not tax companies on business asset gains (except maybe depreciable property) but tax shareholders on gains when distributed as dividends or the shares are sold – i.e. when the gain is realised by a real person.

Rules might need to be developed to prevent individuals using companies to sell assets they, in reality, own and then reinvesting the gains within the company. That would seem to depend on the degree of rollover relief.

If we tax PIE share gains on accrual or FDR basis consideration needs to be given to taxing portfolio shares on the same basis to keep consistency.

All in all, we need more time on these issues.

Specialised Assets

An example is livestock. This has simply been noted by the Group as an issue. More time is needed to reach a conclusion and there seems no reason to bring these assets into the tax base on a rushed basis.

PIEs

For multi-rate and listed PIEs, excluding land owning PIEs, the Group seems to have concluded that they should be taxed on Australasian equities on an accrual basis (with cash out of losses) or FDR (not sure of rate) with imputation credit offset. In my view, with respect to Australian shares, FDR, accruals and exempting gains all should produce a broadly similar outcome. With New Zealand shares, FDR with imputation credits seems to favour New Zealand over Australian shares (by providing a deduction not a credit for Australian tax).

This assumes a portfolio that broadly reflects a dividend return pattern in line with the overall market (the following is not even approximate of an investment in one share such as Xero that is not paying dividends). That is because if we tax under accrual the government assumes the tax portion of the risk of loss and in return gets the tax portion of the gain. The investors have less gain but lower risk. The investors can get the same result by increasing their investment by 1/(1-t) and end up with the same return and risk. The Group proposes taxing only 80% of the accrued gain but this concession is offset (rightly) by allowing only 80% of the loss. Why we propose this is a mystery to me. Is it some sort of lesson in arithmetic?

I would favour allowing PIEs to elect either FDR or accruals – that helps keep the integrity of the FDR rate.

Land owning PIEs should it seems be treated for the purposes of this note as ordinary equity as per the Interim Report.

The implementation issues with PIEs seem to be timing for system changes – 1 April 2022 seems to be recognized as the earliest feasible implementation date.

The largest issue here seems to be public acceptance – can the public be convinced of the approximate equality of exemption for tax on gains, FDR and accrual with losses cashed out. Will people believe that come a stock market crash the government would cash out losses when its own fiscal position is likely to be under pressure?

Staging and Timing Implementation

One issue is to select what property is to be included in the tax base. This may be all the above categories eventually.

The second issue is possibly phasing - bringing in extended tax on a staged basis according to the asset type.

There seem to be two alternatives to staging:

- Deferring the implementation date of the tax extension coming into effect from 1 April 2021 to a later date. This seems most appropriate when simply more time is required to finalise details or allow taxpayers time to build systems etc. to manage the tax change.
- Move from taxing property held on implementation date (the proposal of the Group in the Interim Report) to taxing only property acquired after that date. This is the Australian approach. Views on the Australian approach (which I now understand was the original UK approach) seem to differ. Academics and ATO dislike it with some passion. Private sector advisers suggest it has worked OK and got Australia through the transition without too much pain.

The suggestion has been made that we could adopt the Australian approach but only for SMEs. I am totally against that. It raises complex boundary issues about what is an SME. When do you have to qualify? To make this work it seems that you need to qualify only for the year of implementation otherwise you will never know what will apply when the gain becomes taxable. That seems to produce quite odd outcomes – a large company can get this relief if it so happened it was small at one date.

The third issue is what should be included in legislation to be enacted by July 2020. This seems to me to be all that can be enacted being all that can be well designed and have been through an adequate process. There may be a tradeoff between what is desired and what is politically manageable although the political risks of ill-considered legislation should also be considered.

A Possible Approach

This note aims to set out a menu to which judgment should be applied. It is not intended as a degustation dinner that is pre-selected.

The following illustrates the application of the menu approach.

- Residential rental property – easiest property class to extend the tax of gains on. Tax from 1 April 2021 based on valuation at that date.

- Residential non-rental – decide whether to bring into the base. If so no obvious reason why not 1 April 2021 but with Australian approach making this more manageable.
- Commercial/industrial/farm property. Valuation issue – adopt Australian approach from 1 April 2021 if design issues resolved. Also, consider depreciation option – possibly elective below.
- Business depreciable property. From 1 April 2021 if design issues resolved. Valuation date as at 1 April 2021
- Other business assets, shares/equity – defer to a later date with further work on design issues and extent of tax. But will then apply using Australian approach – only property acquired post-implementation date.
- Other specialized property such as livestock – defer to a later date for design details to be worked through. Valuation implementation date – cannot use Australian approach for livestock.
- Land owning PIEs Defer to allow for design development. Aim to treat as per other business assets/equity.
- Multi-rate and listed PIEs including KiwiSaver. Explore acceptability of election to be taxed on accruals (with losses refunded) or FDR (with imputation credits). If feasible apply from 1 April 2022 (allow for system changes) using valuations on implementation date.

The result would still be significant legislation next year with material extension of tax on gains as of 1 April 2021 but more time to develop legislation on the more complex areas. Most complex businesses and equity deferred for more consideration.

Anyway, my thoughts at this time.

Robin