Tax Working Group Information Release

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Coversheet: Secretariat comment on the idea of exempting capital gains at the corporate level

Position Paper for Session 24 of the Tax Working Group

6-7 December 2018

Purpose of discussion

This paper looks at the idea of exempting capital gains at the corporate level and applying a capital gains tax at the shareholder level as a response to some issues identified with taxing capital gains at the corporate level.

Key points for discussion

- The pros and cons of exempting capital gains at the corporate level and applying a capital gains tax at the shareholder level

Recommended actions

We recommend that you **agree** to not recommend exempting capital gains at the corporate level.

Secretariat comment on the idea of exempting capital gains at the corporate level

Position Paper for Session 24
of the Tax Working Group

December 2018

Prepared by the Inland Revenue Department and the Treasury

1. Introduction

1. The idea of exempting capital gains at the corporate level has been raised as a potential solution to three issues with the Group's main proposal. Those three issues are:

   - It will be costly to come up with a valuation day value for assets like goodwill (**the goodwill valuation issue**)
   - Any rules to deal with double taxation and double deductions will be complicated and perhaps only partially successful (**the double tax issue**)
   - There will be increased taxation of New Zealand equity markets (**the taxing equity issue**)

2. Analysis

2. New Zealand's company tax system with imputation means the company tax operates largely as a withholding tax for shareholders that are New Zealand residents, and a final tax for shareholders that are non-resident. From a domestic perspective, taxing at the company level removes an artificial advantage (if the alternative is not taxing company income) to earning income through a company instead of individually. In the absence of company taxation there would be a strong incentive to accumulate income in companies and not pay dividends or sell shares so that there would be major tax deferral opportunities.

3. In order to prevent deferral, the income base for companies is the same as for individuals (except for some exceptions owing to the different legal nature of companies).

4. Exempting capital gains for companies while taxing them for individuals would be a major departure from this similar income base approach which prima facie should result in efficiency, fairness, and revenue costs. The justification for suggesting this seems to be that there are significant compliance costs relative to revenues, and that there are risks of double deductions and double taxation from applying capital gains tax at both the company level and the individual level. One particular concern has been whether much capital gains tax revenue will be received from corporate capital gains taxation. Evidence from Australia and other countries shows that companies pay a significant amount of capital gains tax, and officials have done significant analysis to recommend rules to minimise instances of double taxation and double deductions (and the Group is suggesting that the government consider the Australian consolidation approach, in case that would be better). Following are more detailed comments.

5. The exemption would require different rules for listed companies, and for closely and widely held unlisted companies, and so this note addresses both separately.

Widely held listed companies

6. Exempting capital gains at the corporate level addresses part of the **double tax issue**. This leaves taxation of capital gains at the shareholder level, through taxation of dividends and a new shareholder capital gains tax. This would still double tax any retained earnings (although the Secretariat notes that it does not consider this to be a major problem given that data on imputation credit balances suggests that most publicly-listed companies pay out imputation credits quickly).

7. As an initial point, it's worth noting that this proposal would not really address the **taxing equity issue**, except to the extent that it removes any **double tax issue**. Even if capital gains are exempt at the corporate level, investors in New Zealand equities will be taxed on their capital gains.

8. At times there will be difficulties in valuation, when listed companies have to determine a gain from selling a particular business. In the Secretariat's view, this **goodwill valuation issue** for publicly-listed companies is unlikely to be significant enough under the Group's current proposal to justify a departure from the underlying principles of the imputation system.

The value of the goodwill of the listed company itself will be reflected in its share value which will be known on valuation day. Goodwill is potentially relevant if a listed company sells an operating subsidiary (which will have its own goodwill component). Even so, in the experience of many countries, corporate reorganisation rollovers often mean it is not necessary to know the value of valuation day goodwill, depending on how the sale is structured.

9. The downside of exempting listed companies is unfairness from exempting the largest companies from the tax, and revenue los as it is unlikely the listed company would pay out the income as an unimputed dividend (while listed companies have a high level of distributing imputed dividends, they are much less likely to distribute unimputed dividends), and many shareholders of the listed company would not pay tax when they sell their shares (because they are non-resident or tax exempt).

Widely held unlisted companies

10. Trying to extend the proposal to unlisted companies creates its own issues.

11. Exempting capital gains for widely held unlisted companies would not solve the **goodwill valuation issue** as those companies would still need a starting valuation including goodwill to measure capital gains if their shares are sold. If this is too difficult, then it has been suggested these shares might be grandparented. But that raises all the problems the Group has identified with grandparenting.

Closely held unlisted companies

12. Closely held companies have the same problems as above, but the additional problem that owner-managers will be able to defer the tax by not selling shares nor paying unimputed dividends. As a solution, there might be a requirement to distribute any realised capital gains in the year they were realised unless rollover treatment were available. In effect though, this means harsher treatment for closely held companies than listed companies, unless there is generous rollover. In effect, closely held companies are treated as though their assets were held directly by their shareholders, and hence not eligible for the proposed exemption from capital gains tax for companies. It also means there is no compliance cost/simplicity benefit for these companies if the capital gain income must be distributed because it means the capital gain income must still be calculated.

3. Summary and conclusion

13. In summary, the option would grandparent goodwill and unlisted shares, and either:
    - Provide extensive rollover for closely held companies
    - Deem distributions of capital gains realised at the corporate level for closely held companies.

14. It would not completely resolve any double tax issues, and would still tax investors on their equity gains. In terms of goodwill valuation issues:

    (a) in the relatively limited circumstance of a sale by a listed group of a business line there should be no issue (no need to value goodwill because sale not taxable); and
    (b) in relation to a sale by a non-listed widely held group of a business, goodwill valuation issues would be resolved only if the shares in the holding company are grandparented.

15. In the secretariat's view, the option outlined is inferior to the main proposal developed by the Group. It would also reduce revenue (to the extent a company is owned by non-residents or tax-exempt shareholders, tax would not be paid even if a dividend is paid or the shareholder sells their shares) and raise equity and integrity concerns if companies are exempt from the tax while individuals must comply.

	Public companies	**Widely held unlisted companies**	**Closely held companies**
Goodwill valuation issue	Unlikely to be a major issue under current Group proposal	If it resolves, it only does so through grandparenting	If it resolves, it only does so through grandparenting
Double tax issue	Partially resolves (still have double tax of retained earnings)	Partially resolves (still have double tax of retained earnings)	Double tax n (manageable if closely held). Solves double deduction problem.
Taxing equity issue	Doesn't resolve	Doesn't resolve	Doesn't resolve
Other points	Likely to result in revenue loss	May require grandparenting of existing businesses	May require grandparenting of existing businesses