Tax Working Group
Te Awheawhe Tāke

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29 November 2018

Taxing Share Gains but not Gains Made by Companies

This note considers some of the detail of an option of not taxing companies on capital gains but instead taxing such gains in the hands of non-corporate shareholders when the shareholders themselves realise the gains whether as a distribution from the company or as gain on the sale of shares. This can be seen as consistent with a broadly based tax on capital gains but one limited to realisation on the basis that only individuals (and entities such as trustees taxed along the lines of individuals) are the real objective of taxation. Company income is that of the individual shareholders and companies are taxed as in effect a withholding tax on the income earned for shareholders. When a company realises a gain but does not distribute that gain to shareholders and shareholders do not sell the shares, then it can be argued that although the company may have realised a gain the shareholders have not.

I note at the outset that a proposal along these lines would be a distinctively different approach than set out in the TWG Interim Report and relative to current law. In the time available this note sets out an outline of an approach – it has not been fully developed or analysed and it follows not consulted on. There is no international precedent as far as I am aware to base this approach on.

The issue the option attempts to address

The option attempts to address three main issues raise in submissions on the broad extension of capital gains taxation as set out in the Interim Report.

1. Concerns re transition as a result of the requirement to value property as at 1/4/21. These concerns are not limited to but focus on businesses and business assets and especially the somewhat nebulous and hard to value concept of “goodwill”.
2. Concerns regarding the high compliance costs especially regarding companies. The necessary anti-double deduction rules for corporates are seen as having very high compliance costs and in addition complex de-merger, script for script and amalgamation rules seems (based on at least some Australian feedback) to result in relatively little tax collected but high costs.
3. Concerns regarding the potential adverse effects of the Interim Report proposals on New Zealand equity markets. This is a range of possible problems from inconsistency of tax treatment individuals and PIEs/KiwiSaver to the double taxation (tax penalty) when shareholders sell shares for a gain in a company with unrealised gains that will later be taxed. What seems clear is that the Interim Report proposal will increase tax on New Zealanders owning shares in New Zealand companies (but not New Zealanders owning shares in foreign companies or foreigners owning shares in New Zealand companies). There has been strong evidence that residential rentals are under-taxed (in terms of reasonable commercial rates of return that are taxed). Some evidence that land in general is taxed (although the case for unfettered roll over for substitute assets seems strong given land prices tend to rise across the board and a person selling land to buy land is having to pay more for the new land and thus can reasonably seen as not realised). There is not much evidence it seems that equity overall is under-taxed at least excluding land rich companies. Put another way there seems to be evidence that under current rules there are tax-induced distortions to investment in land especially residential rentals but not otherwise.

This would suggest a more specific extension of capital gains taxation (to say residential rentals) but if there is a perceived need to adopt a more comprehensive approach the approach outlined below could be explored further.

Response -in general

Continue taxing companies only on revenue account gains (gains already taxable) with imputation but not otherwise. Then tax shareholders on what is distributed to them (dividends) and their gains on sale. In this way capital gains are taxed once – at the shareholder level when in effect they are realised by the shareholder.

The government could still extend the scope of taxed gains – most obviously to residential rentals held by companies. It could also tax the gains on all depreciable assets and if it wanted land (although in my view land needs extensive substitute property roll over as above). The key issue is not to tax hard to value items such as goodwill.

This response seems to work most easily with listed or public companies where management and ownership are separated and there is a reasonable market value for the shares for the transition.

Listed/Public companies

Could consider wider than just listed on stock exchange provided separation owner/manager, insider trading rules etc. apply and readily available market to value.

As above:

- No tax on gains at company level (including share gains). So no tax on goodwill.
- Tax at shareholder level on distributions (including capital gains) and gains on sale of shares.

Issue 1 dealt with (ready value can be given to shares). Issue 2 dealt with since no need for complex rules to handle double deductions etc. May still need de-merger rules. Re issue 3 – not taxing at shareholder and company level so no double taxation of unrealised gains in most cases (as now).

My preference would be to go further and tax the shareholder under a fair return method at 3.5% (no option to use current value when share price falls). Imputation credits can be used to meet fair return tax. Then relatively simple rules and no under taxation.

Unlisted widely held companies

Basically companies that owners cannot treat the corporate assets as in essence their own. Have to take into account minority shareholders and no right to buy them out. Could be "widely held" (25 or more shareholders but that current definition excluded "closely held" which precludes companies where a person and associates hold 50% or more which can be many public companies.

Same as listed

- No tax on gains at company level (including share gains). So no tax on goodwill.
- Tax at shareholder level on distributions (including capital gains) and gains on sale of shares.

But then have a problem of valuing the shares. If that is a problem grandparent existing shareholding. Do not in my view need continuity requirement or to deal with asset changes. When shares are sold gains are taxed (or lose grandparenting). I would have no roll over of grandparenting on death or gifting. No tax but new owner takes new value and is then taxed. Company may sell and buy assets (not taxed so in effect roll over relief) but shareholders cannot use this to hold their own property since minority shareholders involved.

Problem of fair return method is valuation. Danger also of low value company (low FRR) but labour income – professionals in a company paying little FRR tax.

Other (closely held) companies

Issue here seems to be that owner and management can in effect be the same. This seems the most difficult issue to resolve. The problem seems to be that if a company is not taxed on a gain but the shareholder is, the shareholder can hold the property in a company and in effect access rollover relief. A person can put their property into a company. Sell the property (no tax) and repurchase other property or hold cash to invest with no tax. In effect roll over relief for substitute assets when no intention to provide such relief. An example would be holding shares in a company rather than personally. Sell shares for a gain and reinvest. I cannot see any other opportunities this creates but open to suggestions.

Could deal with this by requiring closely held companies to distribute the gains on the sale of "taxable property" to be distributed to shareholders in that year. Taxable property is property that is not taxable in the hands of the company but would be taxable if held by an individual but would also exclude CFC active income or interests in active CFCs (for the reasons given in the Interim Report) and that does not for roll over relief and is not grandparented. For this to work there seems to be a need to grandparent at least hard to value business assets such as "goodwill". This is intended to be a targeted anti-avoidance rule and so should be targeted where otherwise a company can be used to access what is in effect rollover relief when that is not the policy intent. It would thus seem appropriate to limit this to portfolio share interests, rental properties and specified other material property gains that need targeting.

The suggested approach seems more workable the more there is unrestricted roll over relief for in substitute property. If the policy intent is to have no or very limited in substitute roll over relief (the position it seems of the Working Group) it seems likely that this would result in a tax penalty for operating a business through a company.

The requirement to distribute gains to shareholders could be met by an actual distribution (taxable) or a credit to current account – still taxable. Crediting to current accounts means cannot just allocate to the lowest rate taxpayer – the company has a legal debt to that shareholder. Shareholders can agree to turn current accounts into equity if so needed.

Note that any gains so required to be distributed would have no imputation credits so company could not distribute taxed earnings in lieu of gains.

Also in this case have issue with valuation of shares. If an issue may need to grandparent these shares. Grandparented shares will be taxed on distributions but not gains on sale of shares. Again no continuity requirement is necessary – some shares grandparented others not. Also no need for Australian rules re change in the nature of the asset – shares remain the same although could have

rules that if rights attached to shares materially change (move from no right to distribution to right to distribution) then deemed sale and repurchase of shares.

I have also considered LTC etc rules. These are more complex although a lot of the restrictions although much of this seems to be because sale of shares in LTC likely to be untaxed. Most of the issue is the look through treatment which means partnership approach requiring adjustment to the cost basis of all entity property for each owner. In any case the above seems simpler and all that is required and by necessity the LTC rules are only elective. Having looked at this issue it does seem however that the LTC rules could be simplified if share gains are taxed.

Assessment

None of the above is perfect but it should be compared with the Interim Report which we all presumably agree has imperfections even if supported. Also this is just a cursory look at these issues.

My overall assessment is that the problem area is trying to restrict in substitute property roll over relief for property held in closely held companies. This suggests the approach would only be workable with less restrictive roll over relief than the Working Group is now considering. Underlying this approach is that gains should be taxed only when cash or a debt is derived by an individual shareholder. It is argued that this can be seen as consistent with a realisation capital gains tax. There seems to be an inherent contradiction if this approach is adopted but there is restricted in substitute roll over relief for individuals. That policy contradiction leads to the need for rules requiring company gains to be in effect deemed to be distributed to shareholders so we preserve cash realisation only by deeming a non-cash realisation to be a cash realisation which is sophistry.

With all these caveats the option does suggest a way of legislating the essence of a reasonably comprehensive taxation of capital gains, raising most of the expected revenue (residential land and shares) while minimising compliance costs and fiscal risks of bringing property into the tax base by way of hard to measure valuations and minimising what seems to be the main on-going compliance costs associated with overseas capital gains tax rules in the corporate area. This is by way of extensive substitute property roll over relief, taxing shareholders and not companies, and grandparenting shares that have no ready market valuation. It is no clear that the complexity justifies such a pragmatic approach but it would provide an option should Ministers need that.

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