Tax Working Group Information Release

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December 5, 2018

To: Tax Working Group

From: Robin Oliver

Note re double taxation and Option B

This is just a short note on views on a couple of issues relevant I think to our next meeting.

Double Taxation

At the TWG conference and in general feedback the issue has bene raised that extending taxation of capital gains gives rise to double taxation. My view is that there are four senses of double taxation, all different and only one that is a matter of policy concern:

- Income tax itself results in double tax. Income tax is TTE. Tax wages as earned and then interest on wages which can be seen as double taxing income compared to GST which is EET - only one level of tax. This is all true but double tax in this sense is inherent in an income tax. The second T is tax on capital income and the only solution to "double tax" is not to tax capital income at all. This is the point made that there is always double tax on savings and capital gains taxation is no different.
- GST is levied on already taxed income so double tax. Wages are paid and tax levied. GST is applied when those taxed wages are spent. This is double taxation, but the effect is to tax labour income at a higher rate than capital income. The issue is whether this is the right tax balance but the fact that GST is levied on already taxed income does not of itself mean this is wrong in policy terms.
- Taxing capital gains by itself results in double taxation – tax on the gain in the value of the property then tax on the income generated by the property leading to the capital gain. Take the example of a person with a "good idea". For simplicity assume "the idea" produces an income stream for 10 years then nothing. The idea is property and has immediate value. Under a pure accrual capital gains tax this is taxable income as soon as thought up. Then when the income is earned it is also taxed. But the value of the property declines each year until the end of year 10 it is worthless (on the assumption made). Under a pure accrual capital gains tax this results in deductible losses offsetting the tax on the income generated by the property. All that taxing capital gains does is bring forward the timing of the tax on income from the year the property generates cash flow to the year in which the property exists as an asset or increase in wealth of the taxpayer. There is no double taxation. A realisation capital gains tax complicates the issue but the fundamental point re no double tax remains. This is the point made by the 1990 DD that has previously been referred to by officials.

- Treating companies and shareholders as separate taxable entities creates double tax because we tax the company and then the shareholder on what is in substance the same income. This amounts to a tax penalty on new equity raising by companies. We overcome this through imputation by giving shareholders a credit for the tax paid by the company. The problem arises with a realisation-based capital gains tax. As spelt out in the Interim Report imputation continues to work where a company realises a capital gain and then distributes that to shareholders. However, where a company has an unrealised capital gain and shareholders sell the shares, shareholders are taxed on the gain. Then when the company realises the gain it is taxed with no automatic credit for the tax already paid – double tax. As also spelt out in the Interim Report this double tax is mitigated if the company realises its capital gain soon after the shareholder sells and the company then distributes the gain to the new shareholder who then sells the shares and has a loss on the share that it can use. If this is all anticipated at the time of the first share sale that should be factored into the price of the share – the original shareholder receives a higher price for the share in recognition of the future deductible share loss of the purchasing shareholder. That higher share price compensates for the tax on the share gain. In my view this is likely to be the exception rather than the norm.

It is only the last of these double tax scenarios that should in my view be a policy concern. Option B avoids the double tax by taxing only at the shareholder level.

Taxing Shares

Option B is substantially based on my view that taxing share gains on an accrual basis has limited effect provided accrued share losses are also cashed out in the same way as accrued gains are taxed. This is with respect to holdings of a range of portfolio shares. The assumption is that with such a share portfolio the investor is likely to receive a return at least approximately equal to the risk-free rate of return in the form of dividends. The gain in share values is therefore the risk premium. By taxing this risk premium (capital gains on shares) the government takes some of the risk return but provided it also allows a deduction for losses this offsets that. In other words, by taxing accrued share gains and allowing a deduction for losses, the government simply assumes a proportion of the risk borne by shareholders. It assumes a proportion of the risk of loss and in return gets a proportion of the gains. The shareholder has reduced equity risk but pays for this by giving the government a proportion of the risk return. Much like insurance.

The shareholder may not want this insurance cover. But he/she can just increase the amount of risky investment by $1/(1-t)$ and is back to where he/she was. The government generates revenue from this tax, but this is just reflective of the fact that the government has now assumed equity risk. The government could equally just borrow at the risk-free rate and invest directly in the share market perhaps through the NZ Super Fund.

Importantly there should be no efficiency cost or adverse impact on equity markets from such a tax. We do not propose an accrual tax with accrued losses cashed out. Outside PIEs we propose a realisation only tax and losses may not be useable because of ringfencing, locked into companies with no excess taxable income etc. The efficiency cost and impact on equity markets is measured by the degree that the actual tax varies from the theoretical accrual tax.

Option B, by taxing only at the shareholder level, can be seen as the government generating income by assuming equity risk with minimal efficiency costs or equity market impact. This is subject to distortions caused by taxing only on realisation and loss limitations. Of course the argument that taxing share gains somehow improves the equity of the tax system is equally fictitious under this analysis.

That anyway is the thinking underlying Option B. I concede that it would be at least challenging to convince the public about any of this.