# PROTECTING NEW ZEALAND'S TAX SYSTEM:

## Five Rules for a Fair Capital Gains Tax

January 2019

# INTRODUCTION

The Tax Working Group is expected to recommend the introduction of a capital gains tax in its final report, due to be released soon.

The Taxpayers' Union is not opposed to the introduction of a capital gains tax, in theory. The Union's support or opposition to the introduction of a capital gains tax will depend heavily on the detail of the tax: how assets will be taxed; when they will be taxed; at what rate they will be taxed; and the structure of any tax exemptions or roll-over relief.

If the Government treats the Working Group process as an opportunity to improve, clarify and re-adjust the tax system, reform could be acceptable.

If instead the Government uses the 'expert-advice' from the Working Group as a thin ideological veil to excuse the aggressive expansion of taxation and the state, the Taxpayers' Union will be strongly opposed to reform.

Fortunately, recommendations provided by the Working Group are not necessarily final.

As with recommendations reached by the 2009 Tax Working Group[1] and the 2025 Taskforce[2], the Government is well within its rights to amend, exclude, or add to any list of final recommendations from the Working Group if its recommendations are too radical, too unpopular, or too far removed from economic reality.

There will also be significant room at the Select Committee stage to amend any capital gains tax legislation if, once it has consulted with the public and industry, the Government finds certain details or provisions in the proposed capital gains tax regime are unpopular or unworkable.

Given that, if at any stage the Government decides to abandon an otherwise ideological and aggressive capital gains tax, the Taxpayers' Union could accept reform.

Our opposition to aggressive tax reform is not tribal or based on ideological distrust of a centre-left Government: some

1 https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf

2 https://treasury.govt.nz/publications/information-release/2025-taskforce

of the most important reform to the economy in New Zealand's history occurred under a Labour Government between 1984 and 1990.

Our test of the capital gains tax will be based on five criteria, which for the sake of transparency, we are publishing prior to the announcement of any details regarding the Working Group's recommendations.

If the Working Group's recommended capital gains tax violates any of the Five Rules, the Union is likely to will oppose the tax, and will continue to oppose the tax if the violations are not remedied when any legislation is put before Parliament or amended at Select Committee stage.

Our Five Rules for a Fair Capital Gains Tax are:

1. No Valuation Day: Any capital gains tax regime should exclude a valuation day approach in favour of grandfathering assets into the system upon sale.

2. Indexation for Inflation: Any capital gains tax regime must discount inflationary gains, so taxpayers are just taxed on their real capital gains, rather than nominal gains which merely keep up with the cost of living.

3. Revenue Neutrality: Any revenue from a capital gains tax must be used to fund tax cuts in other areas so that the total tax burden does not increase overall.

4. Roll-Over Relief on Death: When a family member passes away and chooses to leave their assets to friends or family members, the capital gains tax should not be levied on the inheritor at this point.

5. Discounted Rate: Any capital gains tax should apply at a discounted rate, instead of at the full personal income tax rate.

This report will explain why each Rule is necessary for a fair capital gains tax.

# RULE 1: NO VALUATION DAY

## Any capital gains tax regime should exclude a valuation day approach in favour of grandfathering assets into the system upon sale.

If the Government and Working Group want the capital gains tax to apply to all assets from the date of introduction (expected to be 1 April 2021), assets will require a valuation effective at that date (hence, 'V-Day'). This will force asset owners to pay for independent valuations of their assets at a huge total cost.

A better alternative would be for the Government to simply grandfather assets in. Assets would only be subject to capital gains tax once they have been traded at least once and therefore have an official 'traded value', preventing asset owners from being forced to pay for an independent valuation.

While this would reduce any revenue from the capital gains tax as assets are progressively brought into the regime (once they are traded), the cost to asset owners from valuation is too large to justify that approach. In addition, valuations are inherently subjective – something that should be avoided.

While some assets won't require independently verifiable valuations (publicly listed stocks have accurate daily prices, for example), all assets subject to the capital gains tax that aren't regularly traded (rental properties, commercial properties, privately held businesses, etc.) will.

## THE COST OF VALUATION

OliverShaw[1] provide a 'conservative' estimate in their reply submission[2] to the Tax Working Group of the costs of adopting a V-Day approach, outlined in the table below:

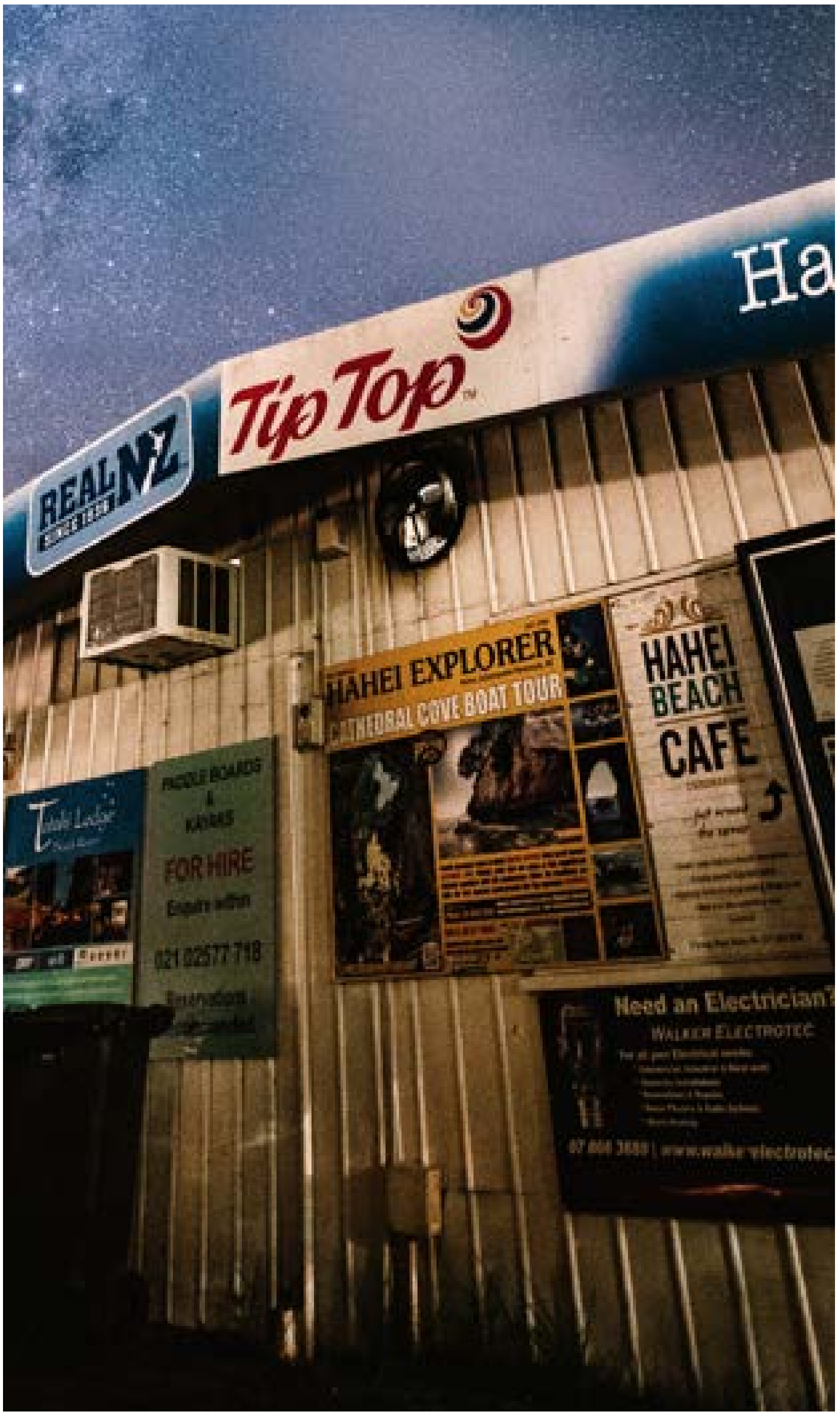
Table 1: Conservative Estimates from OliverShaw on costs of 'Valuation Day'

| Asset | Number of valuations | Cost of Val | $m valuation cost estimate |
|---|---|---|---|
| **Rental Homes** | 600,000 (say 500,000) | $600.00 | 300 |
| **Enterprises** | 534,000 (say 500,000) | $2,000.00 | 1,000 |
| **Second homes and holiday homes** | ? | | |
| **Minority share valuations** | ? | | |
| **Lifestyle blocks** | ? | | |
| **Total cost (conservative est.)** | | | **$1,300** |

In their submission, they explain:

1 OliverShaw is comprised of tax experts Mike Shaw and Robin Oliver. Mike Shaw was a member of the 2009 Government Tax Working Group; Robin Oliver is a member of the current Government's Tax Working Group.

2 Prepared solely by Mike Shaw, given Robin Oliver's membership of the Tax Working Group. Available on the Tax Working Group's website.




> "The cost of the initial valuation will be in excess of [$1 billion], possibly well above [$1 billion], possibly [as] high as $2 to $3 billion. ... (I have sought advice from valuers regarding their level of fees for residential and commercial property valuations including valuations in provincial New Zealand). This level of costs compared with the revenue that may be collected is unwarranted."

> "Adjusting for the above conservative estimates, the total cost on taxpayers of the valuation day option could be $2-3billion."

The submission is correct to label $1.3 billion as too conservative.

## PROPERTIES LARGER THAN 4,500M$^2$

In the Working Group's first report, they explain that while a household's principal residence ('the family home') would be exempt from capital gains tax, there would be circumstances where an exemption would not apply.

For the purposes of calculating the total cost of valuation, the most relevant of these is that if a property is larger than 4,500$m^2$, it would not receive the 'family home' exemption. In absence of an exemption, these properties will require independent valuations, just like every other asset subject to the tax.

There is a huge number of these properties. The Our Land 2018 report prepared by the Ministry for the Environment[3] highlights that as of 2013, there were 175,000 lifestyle blocks covering 873,000 hectares, and that the number of these properties was growing at a rate of 5,800 a year, indicating that the number of these properties may now have exceeded 200,000.

Perhaps more importantly, the average size of these properties is significantly larger than the size required for the property-owners to lose their 'family-home' exemption: the figures from the report indicate an average size of 49,885$m^2$, while the threshold to lose the exemption is only 4,500$m^2$.

Based on reporting[4], that seems to be an accurate estimate of life-style block size: the cited average lifestyle block size is 4ha (or 40,000$m^2$).

While it's difficult to estimate the number of principal residences on land larger than 4,500$m^2$, if the average lifestyle-block is approximately nine-times larger than the threshold, there's likely to be a significant number of homes not classified as lifestyle blocks that still exceed the threshold.

If we assume (based on the Our Land 2018 figures) that there are approximately 204,000 lifestyle blocks around the country, these properties alone will increase the cost of Valuation Day to asset owners by approximately $122.5m (if we conservatively assume the cost of valuing lifestyle blocks with an average size of 4ha is the same as valuing an average rental property[5]). However, this figure could easily explode. If lifestyle blocks are more expensive to value (by virtue of being larger, with additional buildings or structures) the total cost will grow even higher.

## INTRA-CORPORATE VALUATIONS

The availability of price information for publicly listed companies does not completely solve the problem of valuing these companies.

Many large publicly listed companies are horizontally or vertically integrated across their industry. To manage the degree to which these companies integrate themselves across their industry, many companies will dispense with whole going-concerns, or purchase whole going-concerns from other businesses, in order to maximise shareholder value. -

This happens regularly in the New Zealand market.

In 2017, it was announced that First NZ Capital would purchase ANZ's online trading platform for an undisclosed sum[6].

Late last year it was announced that Fletcher Building had agreed to sell Formica to Broadview Holding BV for $1.226 billion[7], after having acquired it in 2007[8].

More recently it was announced that Fonterra planned to "[sell] the livestock division of its Farm Source store and online support network to Carrfields Livestock."[9]

If a company expects to sell any of their going-concerns at any point in the future, these going-concerns will need their own valuations so that companies either pay an accurate amount of capital gains tax in the future or receive an accurate deduction for any capital losses.

3 This report is available at http://www.mfe.govt.nz/sites/default/files/media/RMA/Our-land-201-final.pdf

4 https://www.nzherald.co.nz/the-country/news/article.cfm?c_id=16&objectid=11757794; https://thisnzlife.co.nz/4-things-to-consider-when-buying-a-lifestyle-block/; http://www.stuff.co.nz/business/8740710/Pros-and-cons-of-lifestyle-block

5 $600 per property, based on OliverShaw's submission.

6 https://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11945900

7 https://fletcherbuilding.com/news/fletcher-building-announces-sale-of-formica-dividend-reinstated/

8 https://fletcherbuilding.com/investor-centre/reports-presentations-and-webcasts/2007-acquisition-of-formica-corporation/

9 https://www.newsroom.co.nz/@pro/2019/01/09/393035/fonterra-announces-sale-of-farm-source-livestock-division

The cost of obtaining accurate valuations of many going-concerns (each of which can be large complex institutions in their own right) could be incredibly costly.

This is a problem for privately-held companies as well as publicly listed companies.

If, for example, one of the large ski operators in New Zealand chose to sell one of their fields to an international operator, the field itself (as well as the whole company) would require a valuation.

Importantly though, even if a company is not currently pursuing the sale of an asset, if there's a possibility of future sale, the company will need to pursue valuation on V-Day regardless, given that valuations will need to be accurate as of the date of tax introduction (i.e. the company could not simply pursue valuation when they proceed with an asset sale at a later date).

This will have the effect of forcing companies to receive a series of valuations, split by various wings and departments of the company as a whole, increasing the total cost of the Valuation Day approach.

## SHORTAGE OF VALUERS

There will also likely be a shortage of qualified valuers, allowing prices for their time to be bid up in response to the extraordinary amount of work required compared to regular years, putting further pressure on the total cost of Valuation Day.

OliverShaw's submission notes the likely shortage of valuers:

> "Even if the cost of the valuation was acceptable to the government, New Zealand simply does not have sufficient valuers to undertake the work that would be required. This shortage of supply of valuers would result in either sub-standard valuations and/or valuers coming in from other countries."

This is a problem, given the submission also correctly notes that "valuation is an art, not a science."

Simply bringing in valuers to the New Zealand market, who have very little experience with the commercial environment is unlikely to result in high-quality or accurate valuations that asset owners can rely on for tax purposes.

The lead-in time to train new valuers is also extremely limited.

Valuations will be required to be accurate as of 1 April 2021 – less than two years from when legislation will be introduced to Parliament and, with the introduction of the capital gains tax likely dependent on the result of the 2020 election, approximately six months from when taxpayers can be confident the tax regime will be introduced.

However, given the proceeds of Valuation Day are a 'one-off', any incentive to train as a valuer could be quite limited (i.e. even if there was capacity to train new valuers, attracting people to an industry on the basis of a one-time 'dividend' from training might be extremely difficult).

The result: current expectations of valuation costs are probably too conservative to be reliable. With over a million assets requiring valuation, there will be significant price competition for a very limited number of trained professionals, who will naturally increase their prices.

## MORAL HAZARD AND OVER-VALUATION

At the Future of Tax Symposium in Wellington on 28 November 2018, Working Group Chair Sir Michael Cullen, claimed that asset valuation could be "rough and ready" because the real goal was to ensure assets were quickly brought into the capital gains tax regime.

Adopting a "rough and ready" approach makes sense. It would be impossible for Inland Revenue to audit over a million different assets. That would require Inland Revenue to hire its own valuers to travel around the country assessing valuations and ensuring the independent valuation is a fair reflection of the value of the asset – at significant cost to taxpayers[10].

---

10 https://www.stuff.co.nz/business/108796278/capital-gains-tax-valuation-day-will-cost-kiwi-businesses-billions-of-dollars

In absence of widespread auditing of valuations, there will be plenty of opportunities for asset owners and valuers to provide valuations which merely aim to reduce asset owners' tax obligations. Providing artificially high valuations, for example, would either reduce any capital gains tax liable on the first sale of the asset, or even provide asset owners with deductions to be applied to their remaining tax bill.

Valuers will probably be able to justify artificially high values. Asset valuation – particularly for privately-held companies – is incredibly subjective. Xero, for example, has never made a profit, yet is currently valued by the stock-market as a $6 billion company: its valuation is driven by growth eventually translating into strong profitability.

In the case of Xero, the public market has made that assessment and reflected the company's potential profitability in its share price. Privately-held companies, however, are not subject to share market valuation but might similarly deserve a valuation above the book value of the company on the basis of strong growth potential. Evaluating the company's growth potential for the purpose of valuation would have to be the subjective determination of the valuer employed by the asset-owner: giving significant room to artificially inflate the reported value of the company.

This could significantly reduce any revenue from the capital gains tax – particularly in the early years of the policy, when asset valuations rather than last transaction price inform the baseline price for capital gains tax payments.

Ultimately, the gameable nature of these valuations creates unfairness, as asset holders that pursue honest valuations are penalised relative to those with fewer scruples.

## RESPONSE BY THE WORKING GROUP

After an op-ed which outlined some of the issues from adopting a Valuation Day approach was published, the Working Group released an official response[11]:

> Tax Working Group Chair Sir Michael Cullen says there's no proposal under consideration that would require every New Zealand business to obtain a professional valuation all on the same day.
>
> The assertion is made today in a Stuff opinion column by Troy Bowker.
>
> Sir Michael says the Group is still examining design options for an extension of tax on capital income for its final report due in February and is looking carefully at a range of options that would minimise compliance costs.
>
> "Any suggestion that we would deliver a recommendation that would saddle New Zealand businesses with billions of dollars in compliance costs is absurd and is just blatant scaremongering.
>
> "While an approach that includes assets already owned would require some valuations, the Group is not considering options that would require every asset to be professionally valued, or all valuations to be carried out on the date that the tax would come into force.
>
> "Valuation issues, including options to help small and medium businesses reduce the compliance costs associated with valuing assets, are still being considered by the Group and will form part of the final report to Government."

While it would be good news if the Working Group had chosen to abandon the Valuation Day approach, the careful use of language in this press release indicates that is not the case.

For example, while Sir Michael Cullen specifically says there is no proposal that would require valuations all proceed "on the same day." While that might

11 https://taxworkinggroup.govt.nz/resources/tax-working-group-responds-stuff-article-valuation-day

be true, it misses the point. Valuation Day simply requires that valuations are effective and accurate as of the date of introduction. Even if IRD generously allows businesses up to a year-long window to obtain a valuation, the costs to businesses are still significant.

The statement also claims that while "assets already owned would require some valuations", the Working Group "is not considering options that would require every asset to be professionally valued".

This similarly misses the issues of Valuation Day. While publicly listed companies will not require valuations, many privately-held companies and properties will.

While the Working Group might recommend that Inland Revenue accept Government or Council valuations of properties, these valuations are notoriously unreliable predictors of current market property prices.

House prices for many properties in Auckland, for example, could exceed their C.V. by hundreds of thousands of dollars. Unless asset owners want to pay capital gains tax based on an artificially low base-price for any property they own, a professional valuation will be required.

The Group finally argues that they are "considering options to help small and medium businesses reduce the compliance costs associated with valuing assets".

The only obvious way to reduce valuation costs for small and medium businesses would be to subsidise the cost of valuations, but this simply moves the cost of valuation onto taxpayers, without reducing the total cost of V-Day. Further, a widely-available subsidy for valuation may inflate the price of valuation services, putting more fuel on the fire.

## CONCLUSION

Adopting a Valuation Day approach will cost taxpayers billions of dollars to verify the value of their assets. The total cost is likely to be inflated by the need for lifestyle block and semi-rural property owners, complex companies requiring multiple valuations, and a nation-wide shortage of qualified valuers.

In the absence of a cost-effective auditing process from Inland Revenue, there will be significant scope for asset owners to over-value their asset holdings, putting downward pressure on any revenue from a capital gains tax, and unfairly rewarding dishonest accounting.

While grandfathering assets until their first transaction following the introduction of the tax would reduce revenue in the early years as assets are progressively moved into the capital gains tax regime, imposing billions of dollars of immediate compliance costs (with significant uncertainty regarding the final cost to the economy) cannot be justified.

# RULE 2: INDEXATION FOR INFLATION

**Any capital gains tax regime must discount inflationary gains, so taxpayers are just taxed on their real capital gains, rather than nominal gains which merely keep up with the cost of living.**

The nominal value of assets increases every year by the rate of inflation, in addition to any real capital gain. While real capital gains represent an improvement in the owner's wealth (in terms of purchasing power), the inflation component of capital gains merely represents the asset keeping pace with the value of money.

Given that, any capital gains tax should solely tax real capital gains, rather than nominal gains. Taxing nominal capital gains punishes asset owners when the price of their asset may only be keeping pace with inflation, rather than delivering real increases in wealth.

Any capital gains tax must index asset prices for inflation so that taxpayers are not punished for holding assets that do not increase in value in real terms.

This chapter will open with a brief mathematical description of failing to index for inflation, before moving on to provide some examples of families who could be punished by this style of capital gains tax.

## FORMAL DESCRIPTION OF INFLATION INDEXATION

More formally, where:

$$C_1 = C_{10}(1 + i + r)^t$$

($C_t$ is the value of an asset at time $t$, $C_0$ is the opening value of the asset, $i$ is the average rate of inflation between periods $0$ and $t$, and $r$ is the average rate of real capital gain over the same time period.)

then, supposing the asset is

realised at period t, the tax paid on the asset under a system which taxes nominal gains is equal to:

$$\tau_N = \theta C_0[(1 + i + r)^t - 1]$$

Such that $\tau$ is the total tax paid, and $\theta$ is the tax rate on capital gains.

In contrast, if the capital gains tax is indexed for inflation such that the asset owner is only taxed on real capital gains:

$$\tau_r = \theta C_0[(1 + r)^t - 1]$$

Given that, we can derive a simple mathematical description of the amount of 'over-tax' (i.e. the total amount of tax paid on purely inflationary, rather than real games). This can be simply expressed as the difference between $\tau_N$ and $\tau_R$:

$$(\tau_N - \tau_R) = \theta C_0[(1 + i + r)^t - (1 + r)^t ]$$

Recall that, because this tax applies to assets whether they increase in real terms or not, the inflation 'over-tax' is tantamount to confiscation of a proportion of the real value of an asset, as a function of inflation, the length of time an asset is held, and the rate of tax.

Finally, it may be useful to calculate the value of 'over-tax' in real terms (i.e. what is the size of the tax in real period-zero dollars), which we can obtain with:

$$(\tau_N - \tau_R) = [\theta C_0[(1 + i + r)^t - (1 + r)^t ] / (1+i)^t]$$

## EFFECTS OF FAILING TO INDEX FOR INFLATION

To illustrate these effects, we will use an example with some basic assumptions.

Suppose someone purchases a small lifestyle block property for $800,000 that nonetheless exceeds the 4500m$^2$ principal-residence exemption limit. Suppose they sell the property 20 years later and that over that period of time inflation and real capital gains both run at two percent per annum, and that the taxpayer pays 33 percent tax on any capital gains.

After 20 years, the property will be worth $1,752,898.51 in nominal terms and $1,179,650.45 after adjusting for inflation – a real capital gain of $379,650.45. Assuming a capital gains tax which applies to nominal gains, the property owner will pay $314,456.51 when the property is sold, which adjusted for inflation is $211,620.22.

This is equivalent to a 55.7 percent tax on real capital gains, even though the statutory rate is only 33 percent. If inflation runs slightly higher on average, at say three percent per annum, the effective tax rate on capital gains will be even higher – 64.4 percent, nearly twice the statutory rate.

Failing to inflation index capital gains is also punishing for assets that don't appreciate in real terms.

Suppose a married couple owns a run-down bach which has been owned by various members of the family for a few generations. Since the bach is not the principal residence of the couple, it is subject to capital gains tax, so the couple pays a valuer, who assesses the bach as worth $500,000.

Because the bach is run-down and not in a summer hotspot such as Queenstown or Whangamata, the value of the bach only increases by the rate of inflation with no annual real capital gain.

The Working Group has indicated that passing property down to a relative that doesn't live in the same economic unit (in the same home, sharing the same resources, such as a married couple) will be treated as a realisation event – which means capital gains tax will apply to any gains since the asset was last sold or the tax was introduced.

So, when each of the couple die, whoever inherits the bach – a child, niece or nephew, or cousin – may be liable to pay capital gains tax. For the purposes of this example, let us suppose that is the case, and  that the couple has owned the bach for 25 years since the tax was introduced, over which period of time inflation averaged two percent per annum.

Even though the asset has not appreciated in real terms by one cent, the inheritor of the bach will be forced to pay $80,181.32 in capital gains tax, or $53,959.73 in real terms – which is itself equivalent to 10.8 percent of the real value of the bach, $500,000.

## THE WORKING GROUP ON INDEXING FOR INFLATION

From the Working Group's perspective, adopting a capital gains tax regime which fails to index for inflation is justified for two reasons.

Firstly, they argue that since no other form of tax is indexed for inflation, capital gains tax should similarly not be indexed for inflation. Secondly, "the lack of inflation adjustment is something of a quid pro quo for taxing on a

realisation, rather than accrual, basis."

Tax Working Group member Craig Elliffe makes this point again in an interview for Stuff[1]. He argues that "because a capital gains tax is a "deferred tax", not one that people pay every year, and the benefit that investors get from only paying tax when their profit is realised through a sale can be quite substantial."

The second argument (as presented in the Interim Report) misses the significant distortionary effect of taxing inflation, even on realisation.

While there is very little difference between an accrual capital gains tax and a realisation capital gains tax applied to inflation when the real return on capital is five percent (as assumed on page 152 of the Interim Report) over ten years, the report argues earlier that a one percent annual real capital gain is an appropriate figure to use (page 136) for property.

Similarly, in the background paper Potential high-level effects of proposals to extend the taxation of capital income, prepared by the Working Group Secretariat Westpac model is cited which assumes an annual real capital gain of 1.5 percent. [re-read this para and previous]

The choice of real gains is essential for analysing the effect of a tax on nominal gains. Unfortunately, it is not explained by the Working Group why they choose to use a five percent real capital gains rate, instead of the formerly justified one percent rate, and the Interim Report does not discuss the effect of the real gains choice on the effective tax rate.

By way of example, using a five percent real rate of capital gains implies a 42.7 percent capital gains tax rate, whereas if we instead use a one percent capital gain rate (as argued for on page 136), the effective capital gains tax rate is 90.9 percent.

## CONCLUSION

Failing to index for inflation imposes artificially high tax burdens well exceeding the statutory rates currently being argued for.

While the Tax Working Group might see non-indexation as a quid-pro-quo for choosing to tax on realisation, taxpayers who hold assets that deliver only modest annual real capital gains will face very high effective tax rates – in some scenarios exceeding 90 percent. For the capital gains tax regime to avoid becoming punitive, any gains should be indexed for inflation.

1 Available at https://www.stuff.co.nz/business/109818642/capital-gains-tax--what-we-know-about-how-it- would-work

# RULE 3: REVENUE NEUTRALITY

## Any revenue from a capital gains tax must be used to fund tax cuts in other areas so that the total tax burden does not increase overall.

On 20 September 2018, Minister of Finance Grant Robertson wrote to Sir Michael Cullen[1] in his capacity as Working Group Chair requesting that the Working Group provide "measures that could result in a revenue-neutral package" in its Final Report.

More recently, Tax Working Group member Bill Rosenberg has indicated that the Working Group plans to meet this expectation by either introducing a tax-free threshold on income up to $7,000 or by halving the tax rate on income earned up to $14,000 from 10.5

1 15 Correspondence is available at https://www.beehive.govt.nz/sites/default/files/2018-09/TWG%20letter%20final.pdf

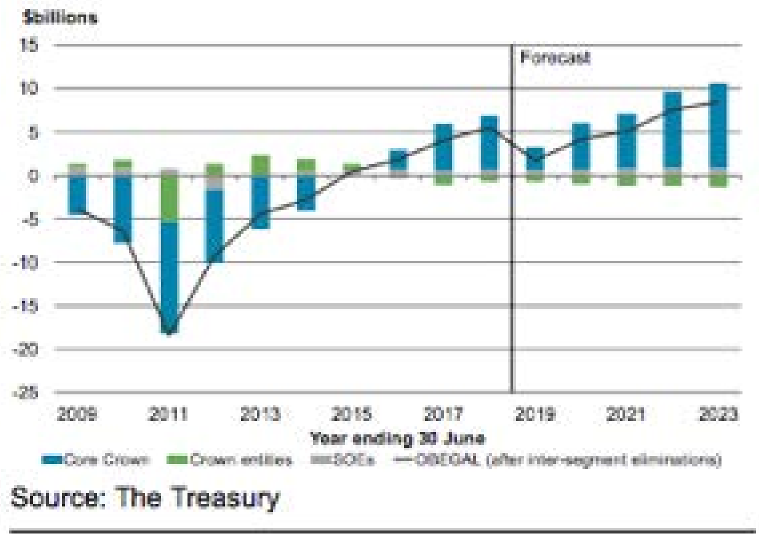



Figure 1: OBEGAL Forecast from Half Year Economic and Fiscal Update 2018 available at https://treasury.govt.nz/sites/default/files/2018-12/hyefu18.pdf

percent to 5.25 percent.[2]

Regardless of the measures the Working Group provides to allow for revenue neutrality, it is crucial that the Government follows through and ensures taxpayers do not face a net increase in their tax burden.

## REVENUE ADEQUACY

There is currently no need for additional revenue.

Unlike the United States and the United Kingdom, both of which are operating persistent deficits[3,4], the New Zealand Government is running healthy surpluses which are expected to strengthen in coming years.

2 https://www.stuff.co.nz/business/109818642/capital-gains-tax--what-we-know-about-how-it-would-work

3 https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicspending

4 https://www.cnbc.com/2019/01/10/fed-chairman-powell-says-he-is-very-worried-about-growing-amount-of-us-debt.html

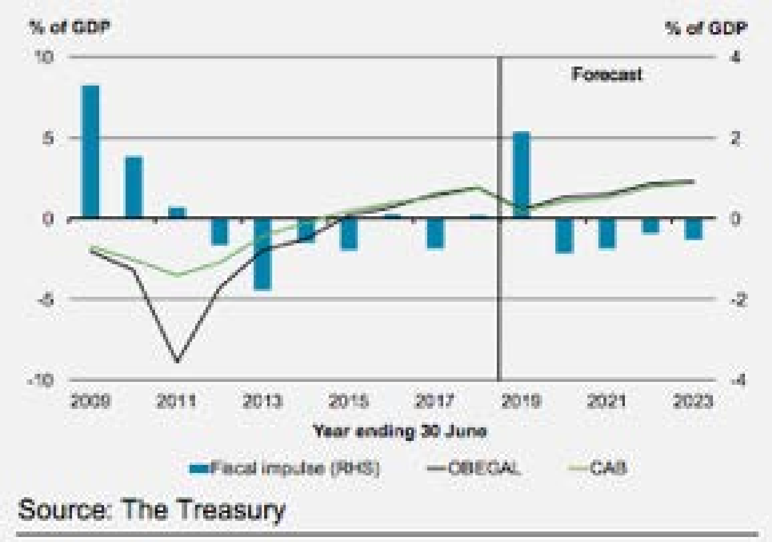



Figure 2: OBEGAL and CAB Surplus Forecasts from Half Year Economic and Fiscal Update 2018 available at https://treasury.govt.nz/sites/default/files/2018-12/hyefu18.pdf

The Crown's OBEGAL (operating balance before gains and losses) surplus is expected to grow to more than $5 billion per annum by 2020, before growing to $10 billion per annum by 2023: the Government should be proposing tax cuts, not tax hikes.

The data shows these are sustainable surpluses.

The cyclically-adjusted balance (CAB) is an adjusted form of OBEGAL surpluses which corrects for the economy's business cycle position, allowing forecasters to establish whether annual surpluses can be attributed to structural factors, or simply an over-heating economy.

The CAB is expected to grow as strongly as a percent of GDP as regular OBEGAL surpluses, indicating that surpluses are structural and there is no need for additional revenue to fund Government services.

While there might be a reduction in revenue during a recession, the Government is structurally taking in more than it needs to operate services and fund transfer payments, so fiscal recovery would quickly accompany economic recovery – in contrast to the years following the Global Financial Crisis when deficits were structural and persistent.

## ECONOMIC COST OF TAXATION

In the absence of a structural need for revenue, increasing the burden of taxation on the economy would just put the brakes on economic growth, reduce future prosperity and worsen living standards.

In particular, a capital gains tax would make portfolio re-allocation more expensive.

This was discussed in the Taxpayers' Union's submission to the Tax Working Group:

> "Capital-reallocation requires a liquidation of an investor's position. Any gain in asset value over the period it has been owned would be taxed. Capital re-allocation is now subject to transaction costs as a proportion of the previous success of the stock."
>
> "That disincentivises re-allocation of capital to more productive investments, reducing investor returns and economic growth. This is described in the literature as the 'lock-in' effect."

Therefore, any revenue gained from a capital gains tax should be used to cut distortionary, growth-stunting taxes.

Company tax in New Zealand is very high, for example. The OECD noted in their 2017 Economic Survey of New Zealand (page 35):

"A higher cost of capital than in most other advanced economies contributes to low capital investment. Also, owing in part to its small size, New Zealand has thin venture capital, stock and bond markets."

"Low rates of capital investment depress wages, with negative consequences for income distribution and inclusiveness."

In addition to company tax cuts, personal income tax cuts could be implemented to ensure revenue neutrality.

In our 2017 report, Five Options

for Tax Relief, we highlighted the cost of fiscal drag. Fiscal drag describes the effect of inflation on tax obligations, where incomes are pulled into higher tax brackets, even if taxpayers are not earning any more in real terms.

Since no Government has implemented tax cuts since the 2010 Budget, the average income earner is worse off by approximately $500 per year solely due to the effect of inflation. Correcting for this effect (via either personal tax cuts or the permanent indexation of tax thresholds to inflation) should be a priority use of any revenue gained from a capital gains tax.

## CONCLUSION

The Government's books are extremely healthy: there is simply no need for additional revenue to fund Government services. Meanwhile, a high cost of capital and a failure to correct tax rates for inflation is hampering prosperity. Any revenue gained from a capital gains tax should be used to fund tax cuts in other areas to ensure taxpayers are not unnecessarily punished.

# RULE 4: ROLL-OVER RELIEF ON DEATH

**When a family member passes away and chooses to leave their assets to friends or family members, the capital gains tax should not be levied on the inheritor at this point.**

Many assets expected to be subject to capital gains tax have sentimental value to families outside of their economic value. Farms, baches, family homes, and businesses built over generation all have value to their owners outside of any income or economic benefit they might generate.

Rollover relief refers to an exemption to a realisation event, with the effect that capital gains tax is not paid when it should have been paid. If rollover relief is granted, capital gains tax will

be liable next time the asset is sold on the full amount of capital gain including the period prior to the rollover relief since the last asset transaction.

If rollover relief is not granted on death, asset inheritors would be liable to pay capital gains tax on any capital gains since the asset was last sold. If a family bach had increased in value by $500,000 since it was purchased, for example, the inheritor would immediately be forced to pay $165,000 in tax.

Few New Zealanders are financially positioned to pay Inland Revenue such a sum at short notice – and especially not in the case of a sudden, unexpected death in the family. A bill from Inland Revenue would be salt in the wound for a family member or friend already grieving the death of a loved one.

The practical response for many inheritors would be to mortgage, or even sell, an asset with sentimental value that has been held within the family for generations.

Some may argue that this is desirable, because, under a capital gains tax regime, holding a farm, bach, or business for generations might grant a relative tax benefit to families (in so far as assets are not sold). However, the family also faces an opportunity cost, as they are restricted from freeing up capital where it might be more efficiently allocated to more profitable ventures.

Where assets have been held by the same owners for a long period of time, the capital gains tax obligations on death (in absence of relief) could be significant. A large family farm held for the last 40 years may have appreciated in value by hundreds of thousands, if not millions, of dollars. Imposing a capital gains tax on death could drive families off their farms, forcing the farms to be sold in order to meet the tax obligations.

Roll-over relief should also be granted when capital gains are re-invested in the same asset class. For example, if you sell your farm to purchase a larger farm, you should not be forced to pay capital gains tax. The investor is not liquidating their position, but rather just recycling their capital into a similar asset: investors should only pay tax once they exit their position.

# RULE 5: DISCOUNTED RATE

## Any capital gains tax should apply at a discounted rate, instead of the full personal income tax rate.

If, as is expected, the capital gains tax will apply at income earners' marginal tax rates, the vast majority of taxpayers subject to capital gains tax will face a rate of33 percent. This is much higher than any previous proposal. Labour campaigned on a capital gains tax of 15 percent at the 2011 and 2014 elections.

### INTERNATIONAL COMPARISONS

In Australia, individuals can discount capital gains by 50 percent if they have held the asset for longer than a year. This means that while the top rate of tax in Australia is 45 percent on income earned over $180,000, the top capital gains tax rate for individuals is only 22.5 percent – approximately one third lower than the proposed 33 percent rate in New Zealand. Taxpayers earning between $90,000 and $180,000 would pay capital gains tax starting at just 18.5 percent.

The United Kingdom has a similar 'discount' system. For 'higher-rate' taxpayers (earning over GBP 46,350), capital gains are taxed at 28 percent on residential property and 20 percent on all other assets subject to capital gains tax.

Canada also has a 'discount' system, where only 50 percent of capital gains are subject to tax. The exact rate varies by province.

While the United States does not have a formal discount system, its capital gains tax rates are much lower than 33 percent. The maximum capital gains tax rate is 20 percent on assets held for longer than one year.

According to analysis from the Tax Foundation, as of 2011 a 33 percent tax rate on long term capital gains would place New Zealand as the third most punitive jurisdiction in the world, behind Italy and Denmark.

## DISCOUNTING CAPITAL GAINS

New Zealand should focus on becoming more friendly to foreign investment, rather than more hostile. In the rest of the world, corporate taxation is trending downwards. The OECD has recently acknowledged that there has been significant downward pressure on corporate tax rates.

The best way to reduce the burden of capital gains taxation would be to apply a discount rate in a similar way to Australia, the United Kingdom, and Canada. Failing to do so would worsen New Zealand's competitive economic environment and dampen inward foreign investment.

A high capital gains tax rate would worsen any lock-in effects, worsening the economic efficiency implications of a capital gains tax.

Coleman (2009) discusses the effect of capital gains, arguing that they increase house prices and raise rents. Similar results are discussed in a Background Paper prepared by the Working Group Secretariat with reference to a model developed by Coleman and Binning that outlines the likely effects of capital gains taxes. The likely outcome is higher property prices and higher rents.

This is despite high property prices often being used as a justification to introduce a capital gains tax.

Naturally the severity of the capital gains tax will exacerbate any effects on the residential property market and applying a discount rate would limit the extent of any damage on rents and housing affordability.

# CONCLUSION

While some on the political left will find a punitive capital gains tax desirable, the Working Group and the Government need to keep the focus of a capital gains tax based on technical reform, rather than the aggressive expansion of the state.

To test that, the Taxpayers' Union will be applying our Five Rules for a Fair Capital Gains Tax to the various proposals and amendments that will emerge in the coming months. Each of the Rules are sufficiently independently important that we will oppose any capital gains tax that violates any single one of our Five Rules.

Fortunately, even if the Working Group releases a proposal which violates one or more of these criteria, there will be opportunities to amend the proposal: when the legislation is put before Parliament and during the Select Committee process. With the legislation likely to take over a year to pass into law, our position on the tax could change if the Government lightens the burden of the tax in response to public consultation.

Each of the Rules represent instances where significant costs would be imposed on taxpayers unnecessarily if they are violated. If the purpose of a capital gains tax is to simply re-balance the tax system towards capital taxation and away from labour taxation – as was discussed at length by members of the Working Group at the Future of Tax Symposium in Wellington on 28 November 2018 – then a discounted, grandfathered, revenue-neutral regime that applies to real rather than nominal gains should be sufficient to make that change. Taxing accrued capital gains on assets that family members have no intention of selling upon death would also be an overreach of that purpose.

# ABOUT THE TAXPAYERS' UNION

Founded in 2013 by David Farrar and Jordan Williams, the Taxpayers' Union is New Zealand's largest taxpayer advocacy group, with more than 36,000 subscribed members and supporters. The Taxpayers' Union's vision is a prosperous New Zealand, with efficient, transparent, and accountable Government. Our mission is: Lower Taxes, Less Waste, More Transparency.

The Taxpayers' Union is a member of World Taxpayers Associations: the global network of more than 55 taxpayer protection groups representing more than two million supporters in some 40 countries working together for lower taxes, limited and accountable government, and taxpayer rights.

TAXPAYERS' UNION

LOWER TAXES, LESS WASTE, MORE TRANSPARENCY

WWW.TAXPAYERS.ORG.NZ