

The taxation of capital gains

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of the
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CHAPTER 1

Introduction

New Zealand is one of the only OECD countries without a general capital gains tax. The Tax Working Group will wish to consider whether a general capital gains tax is worth further consideration.

Content of paper

This paper provides analysis and empirical data to assist the Group in its discussion. It is organised as follows:

- **Section 1** provides a **summary** of the issues and highlights questions the Group may wish to discuss;
- **Section 2** discusses **the case for and against a capital gains tax**, taking into account the objectives set by the Group to guide the design of a good tax system;¹
- **Section 3** considers **the potential distributional implications** of implementing a capital gains tax in New Zealand;
- **Section 4** explains New Zealand's **current approach** to taxing capital gains;
- **Section 5** looks at the **options for taxing capital gains** – accrued, realised or a hybrid of the two;
- **Section 6** raises some common **design questions** that will need to be addressed in any capital gains tax; and
- **Section 7** explores the **revenue raising potential** of the tax.

The case for and against taxing capital gains

The pros...

Although New Zealand has a general “broad base, low rate” framework for taxation, a large component of economic income is not taxed – capital gains. The absence of a comprehensive capital gains tax can distort investment decisions and have equity implications.

¹ These are:

- growth and efficiency;
- equity and fairness;
- revenue adequacy
- revenue integrity;
- simplicity of administration and compliance; and
- coherence.

It appears clear that capital assets are owned disproportionately by higher income families. Not taxing this income is regressive. Taxing capital gains would increase the progressivity of the tax system. It also provides scope for an efficiency-enhancing reduction in the top marginal rates without reducing the overall progressivity of the tax system.

Lack of a CGT favours investments in assets that are expected to appreciate over assets that earn taxable income. These are primarily land and shares. Adding a tax on land would not change the supply of land. However, it could lower its price relative to other investments, which could add to productivity and growth.

... and the cons

Set against this are a range of problems.

Ideally, taxing accrued capital gains would achieve the closest match to taxing full economic income under New Zealand's broad base, low rate approach. However, valuation and cash-flow problems make this difficult to achieve. No country currently has such a tax. The international norm is for a realisation-based capital gains tax.

A realisation-based CGT raises its own practical issues – “lock-in” and double taxing of shares. Lock-in is the tendency of a taxpayer to defer selling an asset to defer the tax. The taxpayer may accelerate selling shares in loss. Empirical evidence on the extent of this problem in practice is mixed. However, rollover relief for certain transactions may be appropriate (e.g. corporate restructurings). Owner-occupied housing presents particular challenges. A realisation-based tax including owner-occupied housing may lead to lock-in, which may discourage labour mobility. But excluding owner-occupied housing can be distorting.

In addition, most countries limit capital losses so as to allow offset only against capital gains. With a realisation-basis this may be necessary to prevent revenue loss from manipulation. However, it may be viewed as unfair when a person with a real capital loss is not allowed to deduct it – or must defer relief until a capital gain is realised.

Taxing share gains raises a double tax issue unless the imputation system could be adopted to cover share sales. This is already an issue for share sales by dealers.

The group may wish to consider when trading off among its objectives:

- the strength of the case for taxing capital gains on the basis of equity (both horizontal and vertical);
- the balance between the prima facie efficiency and integrity benefits in reducing differences in effective tax rates on alternative investment and efficiency costs, such as lock-in;

- the contribution revenues from a capital gains tax – estimated about \$1.5 billion – could make towards efficiency-enhancing reductions in marginal tax rates without reducing the overall progressivity of the tax system; and
- the extent to which the administration and compliance issues associated with a capital gains tax will reduce or outweigh any benefits from the underlying efficiency and equity case for the tax.

Distributional implications for New Zealand

International evidence from Australia and the US suggests that:

- capital gains taxes are sharply progressive; and
- reported taxable capital gains rise both absolutely and as a proportion of reported taxable income.

Both Australia and the US provide a number of exemptions from their respective taxes, particularly around owner occupied housing, meaning that the evidence base is incomplete.

We have no reason to think that New Zealand differs materially from Australia and the US. Data indicates that the distribution of real property and financial assets is highly skewed towards higher income families. That leads to the conclusion that any capital gains tax in New Zealand is also likely to be progressive. Higher income families would bear a disproportionately larger burden of a capital gains tax, although data weaknesses make it difficult to quantify the effect.

The majority of wealth in New Zealand is held as real property, primarily as owner occupied housing. The treatment of that housing is, therefore, important. Its inclusion in any capital gains tax base may reduce the progressive nature of that tax since it is the most evenly distributed property asset in New Zealand.

The Group may wish to consider (from its equity objective):

- whether the progressive nature of a capital gains tax would contribute to fairness;
- whether owner occupied housing should be included within any capital gains tax base.

New Zealand's current approach to taxing capital gains

This section is largely descriptive. It explains that New Zealand's current approach to taxing income from capital is inconsistent, and that a number of capital gains are taxed under different rules. This is resulting in the same form of income being taxed in different ways, at different rates, or not at all.

For example, certain land transactions, dealings in personal property (e.g. shares), financial instruments (through the financial arrangements tax rules), and intellectual property (e.g. patents) are all taxed to an extent. Other land, share and intellectual property transactions fall outside the tax net. The line between ordinary income and other income (i.e. non-taxable) is often unclear.

Options for taxing capital gains

An accrual based capital gains tax

An accrual based capital gains tax taxes the gain in an asset's value over a period with the tax payable at the end of the period (typically annually). On a first-principles basis, gains would be indexed for inflation so that only the real economic gain is taxed. Under accrual taxation, the tax liability arises regardless of whether the asset is disposed of. Declines in an asset's value would be treated as a deductible loss and immediately offset against other income or carried forward.

The key advantages of an accrual-basis tax are:

- the taxation of a closer approximation of economic income;
- neutrality with respect to investment decisions if applied to all assets at the same rate as other forms of income;
- no incentives to bring forward losses and defer gains; and
- more revenue generation potential.

The main disadvantages are:

- the regular valuation of assets;
- cash flow constraints from an annual tax liability;
- the perception that such a tax is unfair; and
- greater revenue volatility for the government.

A realisation-based capital gains tax

A realisation-based capital gains tax would tax the gain in an asset's value when that asset is sold.

The key advantages of a realisation-basis tax are the:

- ability of taxpayers to fund the tax liability;
- existence of a sale price for determining the gain or loss;

- relative simplicity of the concept for taxpayers; and
- relatively lower revenue volatility than a tax on accrual-basis.

The main disadvantages are the:

- incentive to defer the sale of appreciating assets (lock-in) and bring forward the sale of depreciating assets;
- associated complexity with roll-over relief; and
- need to ring fence capital losses to prevent sheltering of ordinary income.

A hybrid approach consists of taxing on realisation those assets where valuation and/or cash flow are a problem and tax on an accruals basis where they are not is possible. However, this approach introduces a new distortion. If, for example, publicly-listed shares are taxed on accrual and unlisted shares on realisation, there will be an incentive for companies to delist.

The Group may wish to consider (from the perspectives of integrity, administration and coherence):

- whether taxing capital gains on an accrued basis is possible in practice given valuation difficulties;
- if this is possible, then the extent to which problems – such as cash flow constraints and taxpayer perceptions of fairness – make this less desirable;
- if accruals based taxation is not preferred, whether taxing capital gains on a realisation or hybrid basis is possible in practice; and
- if it is possible to tax capital gains on a realisation-basis the extent to which problems – such as lock-in, rollover relief, and the treatment of capital losses – make this less desirable.

Design questions

Any capital gains tax design needs to address some substantial issues. These issues are not insurmountable. They are:

- a realised capital gains tax on corporate income would lead to an element of double taxation – a measure of relief may be possible through the New Zealand’s current imputation system;
- a person’s primary residence is usually exempt from tax or taxed at a concessional rate – biasing investment decisions and reducing revenue, but reducing lock-in concerns;
- whether to ring-fence losses from capital such that they can only be offset against capital gains and not other income;

- how to treat gains from inflation – which are possible to remove from tax by way of indexation, but at the cost of increased complexity and compliance costs;
- how to deal with capital gains arising on death or migration;
- the transition to a capital gains tax can be done in three ways. Apply the tax either to:
 - gains and losses from assets acquired after the date of introduction (“grandfathering”);
 - only gains and losses accumulated after introduction date from assets held on or acquired after the date of introduction (“valuation day”); alternatively, treat the initial valuation as the higher of the market value on the date of valuation or the original cost; or
 - apply a valuation day to those assets that are easy to value and grandfather all other assets (hybrid basis).

The analysis in this paper assumes that the same rates of tax that apply to ordinary income would also apply to capital gains. Consideration of a different tax rate structure would require further analysis.

The Group may wish to consider (from perspectives including integrity, administration and coherence):

- the extent to which double taxation is likely to occur in practice;
- whether the imputation system may be adapted to cover capital gains on selling shares;
- whether to exempt a person’s principal primary residence;
- whether to tax capital gains on a real or nominal basis;
- whether death and/or migration should be taxable events; and
- the lock-in, investment allocation and revenue implications of the different transition approaches.

Revenue implications

This section indicates the revenue generating potential of a capital gains tax. Excluding owner-occupied housing, we estimate that a capital gains tax would raise around \$4.5 billion per annum at current tax rates. If owner-occupied housing is included, the revenue projection is about \$9.1 billion per year. This estimate includes land and share investments, and assumes that long-term (about 30 year) real growth rates continue and inflation is reasonably stable. The revenue estimate was made by forecasting capital gains accruing in future years. A realised capital gains tax would be expected to raise something less than that. In addition,

the estimate is overstated to the extent it includes disposals that we would tax now as revenue account property, however, we lack the information to make a specific adjustment for this. The revenue estimate is very sensitive to the assumed appreciation rate. A one percentage point change in the rate of appreciation of real property would have an approximately \$1 billion effect on revenues.

Consideration of transitional issues is important. If the tax applies only to gains and losses from assets acquired after introduction date, it would take some time for a large asset base to be subject to the tax. Australia took this approach and its data suggests it would take about 15 years for the full revenue potential to be realised. Further, Australian data also shows high volatility in capital gains revenue, as share and property markets rise and fall.

CHAPTER 2

Should we tax capital gains?

Introduction

A tax on accruing capital gains would be part of a comprehensive economic income tax as capital gains form part of economic income.² Such a tax on comprehensive economic income is sometimes referred to as a Haig-Simons income tax. Taxing gains on accrual is the other side of allowing depreciation deductions on assets which fall in value over time. In theory, an accrual tax on capital gains that allowed losses on an accrual basis would be neutral between investment and savings options.

The absence of a comprehensive capital gains tax can distort investment decisions. Consider a taxpayer facing a 30 percent tax rate who has \$1,000 and two possible investments that can be undertaken. The first is in an asset which produces \$100 of revenue one year later and is expected to still be worth \$1,000 immediately after the revenue is received. This provides \$100 of economic income before tax. Assuming the revenue is taxed; the investor pays \$30 in tax and receives \$70 of after-tax income. This is option A in Table 1 below. The second possible investment is in an asset which costs \$1,000, which produces no taxable revenue and which is expected to be worth \$1,080 at the end of the year. The economic income on this asset is its accruing capital gain of \$80. This is untaxed. The investor receives after-tax economic income of \$80 by investing in this asset. This is option B in Table 1 below.

It is worthwhile noting that a non-taxpayer would choose option A over option B because this has the higher pre-tax income, our taxpaying investor will choose option B ahead of option A. This is because this provides the higher after-tax income even though from the point of view of New Zealand as a whole, option A is the better investment.

Table 1 Investment choices and after-tax income

	Option A (\$)	Option B (\$)
Cost of asset	1,000	1,000
Revenue	100	0
Tax	30	0
Value of asset at year end	1,000	1,080
Benefit to NZ from investment (i.e. pre-tax economic income)	100	80
Benefit to taxpayer from investment (i.e. post-tax economic income)	70	80

² The sum of the value of consumption and increase in wealth (e.g. increase in the value of capital owned) over a period.

Equity and fairness

There are equity and fairness arguments that can be mounted in favour of a capital gains tax.

Equity with respect to how tax burdens fall on taxpayers is important for acceptance of, and compliance with, the tax system by the community. This is particularly important in a self-assessment-based tax system. Given the difficulty in universally defining what is “fair”, two fundamental principles of equity have been developed when considering the “fairness” of the manner in which a tax burden falls. These principles are horizontal equity and vertical equity.

Horizontal equity is the notion that taxpayers in similar circumstances should have a similar tax obligation. If one accepts that those with the same levels of economic income are in similar economic circumstances, then taxing capital gains is consistent with horizontal equity because it means an individual who earns the same amount of capital gain income as another who earns salary income will have the same tax liability.

The concept of vertical equity however, stimulates much more debate. Vertical equity relates to ensuring that tax burdens imposed on persons in different circumstances are also fair. However, identifying a “fair” burden in different situations is a contentious issue. Most countries tend to provide an interpretation of vertical equity in the tax system by adopting a “progressive” tax rate structure – that is, one where the ratio of tax burden to income increases with increasing income. This is often characterised through a system that levies increasing marginal income tax rates as taxable income increases.

In theory, there could be other ways of assessing whether or not a tax system is horizontally and vertically equitable. For example, while two people had the same economic income, one might have a pleasant job (e.g. an academic) and another a much less pleasant or hazardous job (e.g. an asbestos miner). These two people might have the same income. Nevertheless, in principle, it might be argued that overall well being or “utility” is a better measure of welfare so that it would be fair to tax the person with the less pleasant or more hazardous job at a lower rate. In practice, it is impossible to measure utility so horizontal and vertical equity are often measured in terms of economic income as the best practicable approximation to overall welfare.

Even here, however, there are potential issues requiring further thought. Suppose for the moment that we were to have a comprehensive tax on economic income. This would include taxing all accruing gains, including those from owner-occupiers’ own homes. (Ignore for the moment the potential valuation and cash flow problems associated with such a tax.) Consider a retired couple on a fixed income who are living in a home which they like and wish to remain in for the rest of their lives. Suppose that they are only interested in living in the house and have no interest in passing on a bequest when they die. If their house appreciates in value, this is a form of economic income. But they might reasonably claim that this makes them no better off and to tax them on this accruing capital gain is unfair. Some people may disagree about how fair it would be to tax all forms of economic income.

Nevertheless, analysis of data from the United States and Australia show that their capital gains taxes (both of which largely exclude owner-occupied housing³) are steeply progressive due to the fact that statistically higher income individuals and households tend to earn a higher proportion of their total income as capital gain. Distribution of capital gain income is fairly low and flat for incomes up to \$100,000 in both countries, but then tends to rise sharply with higher incomes. If New Zealand is similar, this would suggest that omitting to tax capital gains is likely to favour the rich. Many would regard this as unfair. Especially in the context of considering moves to cut higher marginal tax rates and to move to a more aligned tax system, there would appear to be fairness grounds for considering whether or not to introduce a general capital gains tax.

Integrity of the tax system

A capital gains tax is generally said to support the integrity of the tax system by reducing opportunities for tax planning and tax avoidance. For example, a New Zealand company could currently develop some intellectual property and sell it to an offshore associated company for an untaxed capital gain, and then license the intellectual property back and pay a tax deductible royalty. If we taxed capital gains then there would be no tax advantage to this transaction (assuming the sale price were fairly valued as the net present value of the future royalties). Evidence supporting the value of a capital gains tax as a “backstop” against tax avoidance is largely anecdotal but it seems fair to think it would have some positive effect.

Efficiency considerations of taxing gains on particular assets if not all gains can be taxed on accrual

As was illustrated in our earlier example, in theory, there is a strong attraction for a comprehensive income tax which would tax accruing gains on assets that appreciate. It would likewise be attractive to allow deductions for accruing losses on assets that depreciate. This would mean that taxes would not bias investment decisions. Those investments that would be efficient for a non-taxpayer to undertake would also be efficient for taxpayers to undertake. If certain forms of income are exempt from tax, this will create a bias favouring investment in assets which produce such income ahead of assets producing fully taxed income even where the assets producing fully taxed income are more efficient. In theory an accrual-basis capital gains tax would add to capital productivity.

However, in practice, no country has a general capital gains tax on accruing gains. If New Zealand follows this international norm, the issue we need to confront (and the issue that was confronted by the McLeod Review) is whether or not there would be efficiency benefits from bringing in a “real world” capital gains tax which is likely to involve taxing realised capital gains (although it could potentially also include a tax on some accruing gains such as possibly gains on shares in listed companies).

³ The United States taxes capital gain on the sale of owner-occupied housing only to the extent the gain exceeds \$250,000.

The efficiency benefits of doing so depend largely on whether or not there are likely to be assets which generate systematic gains where these gains are untaxed and of the efficiency benefits of taxing these gains. It should be noted that it is only to the extent that assets are expected to systematically appreciate that there is likely to be an efficiency case for taxing the gains. If gains and losses were random, from an efficiency standpoint it would not matter whether these gains and losses were taxed or not.

Where assets generate systematic gains, these are often brought into the tax net and taxed on realisation (such as forestry). Relative to a Haig-Simons tax, there can still be a tax preference to these activities because gains are taxed only on realisation rather than as they accrue. A realisation-basis capital gains tax would have the same effect.

The major assets on which capital gains tax is likely to be collected are shares and property. Thus, the efficiency and equity benefits of introducing a general CGT depend largely on the efficiency and equity benefits of extending the tax net to gains on these assets.

Shares

If we had an aligned company tax system and a fairly comprehensive income base at the company level, systematic forms of income would be largely taxed at the company level. For income taxed at the company level, there could be an element of double taxation if firms had not distributed this income and if the retained earnings were reflected in higher share prices and gains in shares were being taxed on sale. Here, if anything, efficiency arguments would appear to tend to push us in the direction of not wanting to tax such gains. Whether or not this is an important issue is an open question. Firms can issue bonus shares instead of paying cash dividends and still allow imputation credits to flow to shareholders. The open question is whether or not this is a sufficiently low transaction cost way of remedying this problem. However, the bottom line is that there is a case, if anything, against a tax on capital gains on shares in these circumstances.

There are at least three counterarguments. First, share values will depend on expectations of future profits, so will exceed currently retained earnings. This is likely to be especially important for those firms will invest in developing products and processes which are expected to generate real increases in revenues over time. These will tend to generate accruing capital gains and failing to tax these can produce a bias favouring investment in such products and processes.

Second, we have decided to tax unimputed dividends on shares. This buttresses the domestic company tax base by reducing the benefit of avoiding tax. It also means that income that New Zealand companies derive from offshore is taxed on distribution. This tends to increase the efficiency of investment from the perspective of New Zealand's national welfare and reduces incentives for profits to be streamed abroad. Introducing a capital gains tax on shares would bolster the taxation of unimputed dividends because profits which had not borne New Zealand company tax and which had not been passed out as unimputed dividends would add to share values and be subject to CGT when shares are sold.

A third counterargument is that alignment is fragile. Especially if there are ongoing cuts to company tax rates in Australia and other countries, future governments may consider that New Zealand needs to cut our company tax rate too but be unwilling to bring down personal tax rates in line with the company rate. In the absence of a capital gains tax there are likely to be ways to make the company tax a final tax. These concerns provide grounds for capping the PIE tax rate at the company rate but if we don't have an aligned tax system this leads to obvious coherence problems. An associated issue is that even if we have alignment, companies may provide ways of sheltering income from higher effective marginal tax rates associated with the abatement of working for families tax credits or other forms of social assistance. A CGT would provide a way of reducing pressures caused by misalignment of marginal tax rates or effective marginal tax rates.

Against these considerations must be balanced a range of other efficiency issues. If gains on shares are taxed on a realised rather than accrued basis:

- there will be lock-in effects which may distort portfolio allocation by discouraging individuals from selling shares that have increased in value substantially;
- there is likely to be a need to ring fence capital losses with capital gains so that capital losses may only be offset against income from capital gains. For those with undiversified portfolios, gains will be taxed but there may be little chance of having other capital gains income against which to offset a capital loss; and
- there will be practical issues such as whether rollover relief should be provided for company reconstructions, mergers and acquisitions and detailed design issues which may at times reduce complexity and at other times increase complexity.

These sorts of issues (rather than any in-principle attractions in a Haig-Simons income tax) will be the key efficiency considerations when considering whether or not to tax capital gains on shares on a realised basis. Moreover, deciding on detailed design issues (such as whether gains if they are to be taxed should best be taxed on realisation or accrual, whether or not to ring fence and provide rollover relief and so forth) is an essential first step before one can reasonably examine whether a capital gains tax on shares is likely to enhance or reduce economic efficiency.

Real property

The other major source of revenue from a CGT would be in respect of gains on real property (i.e. land and buildings). Here property values will consist of both land and buildings. The major source of expected real appreciation would be expected to be gains on land.

Subject to one qualification, failure to tax gains on land will lead to higher land prices but this will not have direct effects on deadweight loss because land is in fixed supply. The qualification is that there may be some tax-induced bias as to who holds land with the lack of a tax on accruing gains meaning that this is an attractive asset for those on higher tax rates to acquire. It can thus produce a bias in who owns land. But it will not distort how land is used.

It should be noted that especially if the CGT were indexed it would be unlikely that buildings themselves would generate systematic real gains. This means that apart from asymmetries caused by loss ring fencing, there would not be expected to be a large revenue pool from taxing gains on buildings. This would therefore not reduce incentives that may currently be there for owner-occupiers to invest in too large or too fancy a house. The systematic part of the tax is likely to fall mainly on land.

In principle, a comprehensive accrual basis tax would lower the value of all land and would be an efficient lump sum tax. If (as in Australia) capital gains on owner-occupied homes are left out of the tax net while gains on other forms of land are taxed, this will tend to create a deadweight loss relative to a comprehensive accrual tax on all land and possibly relative to the current lack of a capital gains tax. If on the other hand, there were a tax on realised capital gains and owner-occupied housing were brought into this net, there could be concerns about lock-in. One might imagine important impediment to households shifting houses which may discourage labour mobility.

Again there is the question of whether or not rollover relief should be provided to households or businesses that shift premises. Once more it is impossible to be very clear about the likely efficiency effects of extending a capital gains tax to real property without first determining what sort of capital gains tax one has in mind. The Group may wish to consider whether a capital gains tax on property will tend to increase rather than decrease deadweight loss.

There is, however, another issue which may impact on GDP and growth. The absence of a capital gains tax will tend to increase land prices which may lead to more savings being absorbed by property assets than would otherwise be the case. A benefit that Treasury would see in subjecting real property to capital gains tax is that this would reduce property values which might increase savings available to be invested in productive New Zealand businesses.

Other assets

A capital gains tax might help in taxing certain other gains such as those on intellectual property. This might have some efficiency and equity attractions.

CHAPTER 3

Potential distributional impact of a capital gains tax

Introduction

The purpose of this section is to consider the potential distributional implications of implementing a capital gains tax in New Zealand. Specifically, the discussion considers how the tax burden might fall based on the limited available evidence. To inform the discussion given the limited information in the New Zealand context, the note also considers how the CGT burden is distributed in the US and Australia.

New Zealand does not currently have a general CGT and therefore does not have a robust information collection mechanism in place to capture capital gains information. In situations where New Zealand does tax gains (e.g. through the revenue account property provisions), the income is in many cases treated as ordinary business income (potentially added to other sources of business income in the income tax return), making specific identification of capital gains amounts impossible. While the existing IR10 form (which provides a summary of profit and loss information as well as information in respect of assets and liabilities) may capture some capital gains information, the IR10 is not widely used so it is not considered a reliable information source.⁴ Accordingly, data on capital gains derived in New Zealand is extremely limited, hampering any robust analysis of the potential distributional effects of moving to a more formal CGT.

We start by discussing some of the CGT distributional evidence available in the US and Australia. The data in these jurisdictions are superior to that of New Zealand, and it is therefore a useful starting point to examine how CGT burdens are actually distributed in other CGT regimes, when considering the implications of a CGT for New Zealand. The specific design of the CGT in these countries is likely to differ from any that may be introduced here, meaning the results should be treated with some caution. We then look at relevant evidence in the New Zealand context, and what this can tell us about the potential distributional impact of a CGT in New Zealand. Our analysis primarily draws on data obtained through the Survey of Family, Income and Employment (SoFIE).

The distribution of capital gains in the US and Australia

While New Zealand has very limited information in respect of capital gains, the US and Australia have richer sources of information to aid in distributional analysis. Provided below are some data showing how capital gains and other forms of income are distributed (predominantly) among individual taxpayers, by income band, in both Australia and the US.

⁴ Inland Revenue is in the process of improving the tax return information requirements which will aim to capture a richer set of data for policy decisions in future.

While conclusions are not directly transferable to New Zealand given the differences between demographic features as well as the differences in the tax systems of each country, the data could potentially shed light on how the broad shape of the distribution of a CGT burden in New Zealand might look were New Zealand to adopt a more formal CGT.

U.S data

The U.S. has more comprehensive data than New Zealand in respect of capital gains. In 2006,⁵ 13.4 million individual taxpayers (from 138.3 million) reported taxable net capital gains⁶ and another 4.6 million taxpayers had capital gains distributions from mutual funds.

Table 2 below shows the distribution of individuals' capital gains⁷ by Adjusted Gross Income (AGI)⁸ for the 2006 tax year:⁹

Table 2

Adjusted Gross Income (AGI)	Percent of Returns	Percent of AGI	Percent of Capital Gains	Percent of Returns with Capital Gains	Gains as Share of AGI
<\$75,000	80.3%	36.8%	6.2%	8.5%	1.8%
\$75,000-\$200,000	16.8%	32.0%	11.2%	27.1%	3.6%
\$200,000-\$1 million	2.7%	16.1%	22.0%	53.9%	13.5%
\$1 million +	0.3%	15.1%	60.6%	76.3%	39.5%

Figure 1 and Figure 2 depict some of the key information graphically:

Figure 1

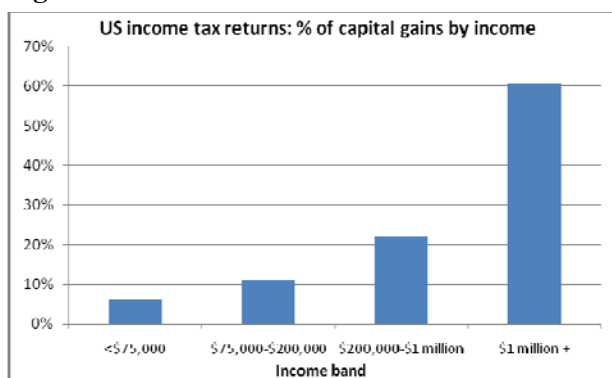
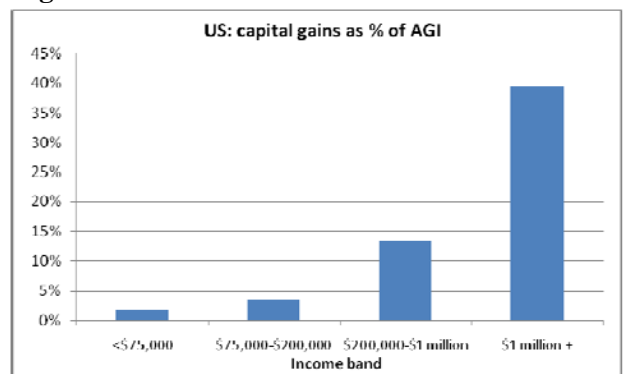


Figure 2



⁵ The 2006 tax year has been selected as the year with the most complete evidence to date (including studies).

⁶ Net long-term capital gains in excess of net short-term capital losses gains distributions (taxed at favourable rates).

⁷ Calculated as the sum of net capital gains on schedule D plus capital gains distributions reported only on the 1040 (income tax form for individuals). Excludes short-term gains taxed as ordinary income. *Source:* IRS Statistics of Income, Individual Income Tax Returns, 2006, Table 1.4 and author's calculations (author: Eric Toder, Tax Notes, August 4, 2008).

⁸ Adjusted gross income is broadly comparable to the concept of taxable income in New Zealand. AGI is effectively the total of gross income sources less expenditures incurred in deriving those gross income sources, before itemised deductions have been subtracted.

⁹ In the U.S. this is the period from 1 January 2006 to 31 December 2006.

The data indicate that:

- high-income individuals derived progressively more capital gains (relative to lower income earners) as their income rises;
- those earning above \$75,000 derived approximately 94% of the capital gains. Further, very high-income taxpayers (i.e. those earning \$1 million or more) derived approximately 61% of the capital gains, with over three-quarters of the returns filed by this group containing capital gains income.

The data in Table 2, Figure 1 and Figure 2 show that the vast bulk of individuals' capital gains were reported by high-income taxpayers, and that an increasingly larger proportion of taxable income was made up of taxable capital gains as the level of taxable income increased. This shows that high-income earners bore the largest share of the CGT burden.

Figures 3 and 4 show the 2006 and 2005 distributions of individuals' capital gain income and qualified dividend income (QDI):

Figure 3

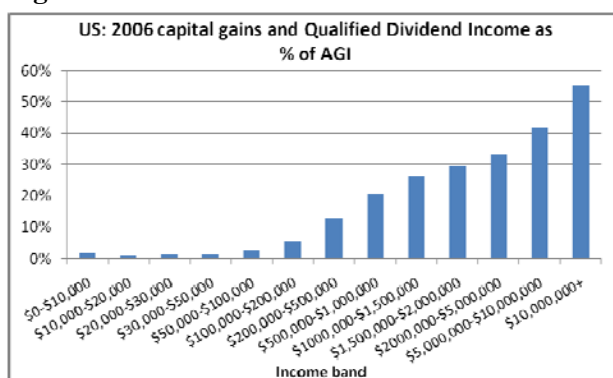
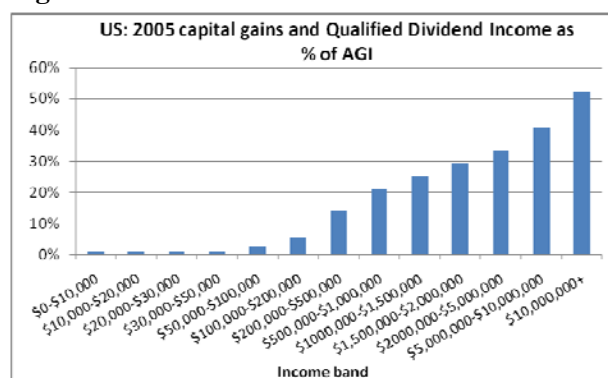


Figure 4

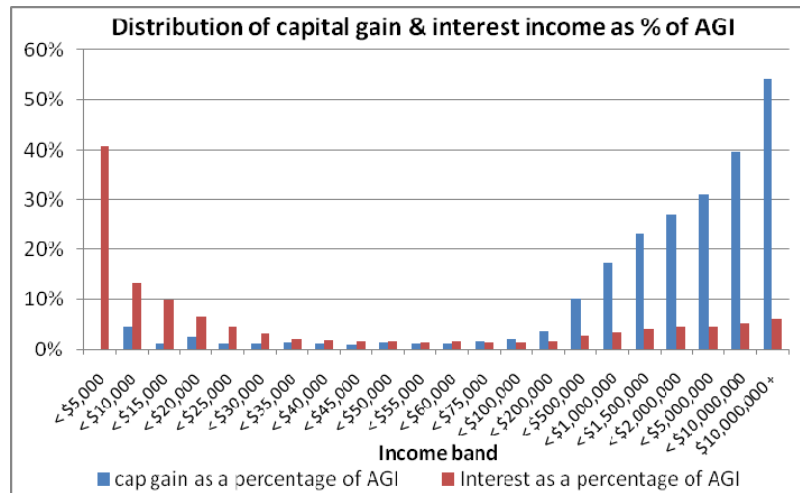


As Figure 3 and Figure 4 depict, in the U.S. context, the capital gain and QDI¹⁰ income as a percentage of AGI increased rapidly as income rose. The data clearly shows that the largest burden of the CGT was borne by high-income earners. Low income earners tended to bear very little of the CGT burden.

¹⁰ QDI is similar to gross dividend income in New Zealand, although in the U.S. QDI is taxed at a preferential rate (the CGT rate). They are taxed in the same manner to ensure that there is no difference in tax treatment with respect to income earned as a capital gain on the sale of shares or through the payment of a dividend in respect of those shares. This data is sourced from a study looking at the burden of capital gains taxes in the US performed by Martin Sullivan (Tax Notes, August 11, 2008) and from Internal Revenue Service Taxation Statistics.

Figure 5 shows the distribution of U.S. individuals' capital gain income¹¹ and interest income as a percentage of adjusted gross income (AGI), by detailed income band, for the 2006 tax year:

Figure 5



The data indicate that high-income earning individuals generally had the largest share of capital gains. Further, the share of capital gains increased with rising income levels (illustrated by the rising share of capital gain income relative to AGI). As a corollary, the tax burden in respect of capital gains was borne more heavily by high-income individuals. This would tend to suggest that the taxation of capital gains increases the progressivity of the tax system.

Thus, if the distribution of capital gain income and interest income in New Zealand follows a similar pattern to the U.S., a CGT might be a way of financing cuts to higher marginal tax rates which would reduce disincentives to work and savings and increase tax integrity without necessarily reducing the progressivity of the tax system.

Australian data

Australia also has some useful data for analysing the distribution of capital gains across taxpayers. The Australian Tax Office's (ATO) 2006/07 Taxation Statistics estimate that \$17.3 billion in capital gains tax was payable in relation to \$72.1 billion of net capital gains. Individuals accounted for approximately 44% of tax on around 33% of net capital gains; taxable companies accounted for 34% of tax on almost 31% of net capital gains; and taxable funds accounted for over 22% of tax on just under 36% of net capital gains. Data used in the following analysis is sourced from the ATO's Taxation Statistics for the appropriate years.

¹¹ Defined for this purpose as *net gains from the sale of capital assets plus net gains from the sale of property other than capital assets* (Source: Individual Income Tax Returns with Itemized Deductions: Sources of Income, Adjustments, Itemized Deductions by Type, Exemptions, and Tax Items, Individual Complete Report (Publication 1304), Table 2.1, IRS Taxation Statistics).

Capital gains and CGT liabilities were distributed across these three groups as shown in Table 3:

Table 3 Tax payable on capital gains, by entity, 2006–07 income year

Entity	All Taxpayers (Nbr)	Taxable Taxpayers ¹² With Net Capital Gain (Nbr)	Net Capital Gains (\$m)	Tax on Net Capital Gains ¹³ (\$m)
Individual	11,799,231	1,148,440	23,966	7,551
Company	750,277	21,944	22,247	5,906
Fund	321,700	115,681	25,880	3,892
Total¹⁴	12,871,208	1,286,065	72,093	17,348

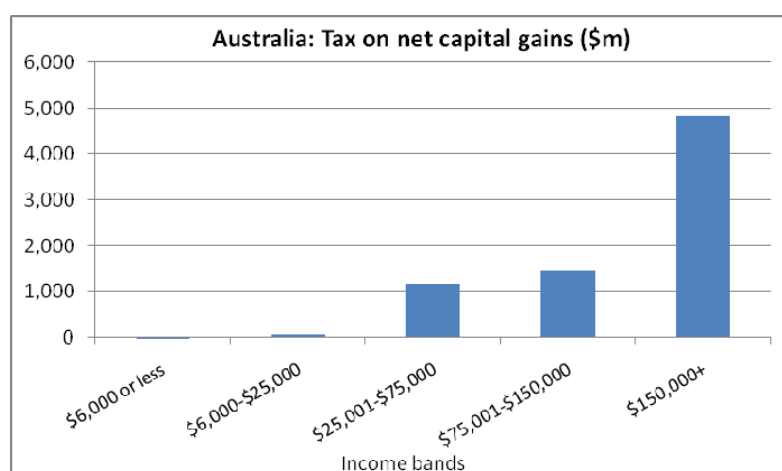
Given that we cannot identify the beneficial owners of capital gains realised by companies and funds, we will analyse the individual data to determine the distributional consequences. Table 4 below provides a snapshot of the 2006/07 distribution of capital gains of individuals by taxable income bands:

Table 4

Taxable Income	Taxpayers (Nbr)	Net Capital Gains (\$m)	Tax on Net Capital Gains (\$m)
\$6,000 or less	4,407	21	3
\$6,000-\$25,000	156,755	1,197	81
\$25,001-\$75,000	658,150	6,018	1,163
\$75,001-\$150,000	238,926	5,126	1,473
\$150,000+	90,202	11,603	4,831
Total	1,148,440	23,966	7,551

Figure 6 shows the distribution of the CGT burden by income band for 2006/07:

Figure 6



¹² Taxpayers with net tax greater than \$0.

¹³ Estimated tax based on entity type and tax rates.

¹⁴ Totals may differ from sum as a result of rounding.

During the 2006/07 income year, of individuals with net capital gains, over 57% had a taxable income level of between \$25,001 and \$75,000 inclusive. They returned over 25% of total net capital gains and were liable for over 15% of the tax on these gains. Individuals with a taxable income of \$150,001 or more accounted for over 48% of net capital gains and 64% of the associated tax thereon.

As can be seen from Table 4 and Figure 6, the bulk of capital gains were derived by high-income earners and, as a result, the tax burden in respect of capital gains was progressively larger on high-income earners. This would indicate that the CGT in Australia displays progressive characteristics (consistent with the principle of vertical equity).

Figures 7 and 8 below show the distribution of individuals' net capital gains as a percentage of total taxable income for the 2005/06 and 2006/07 years respectively. Figure 8 also demonstrates interest income as a percentage of total taxable income:

Figure 7

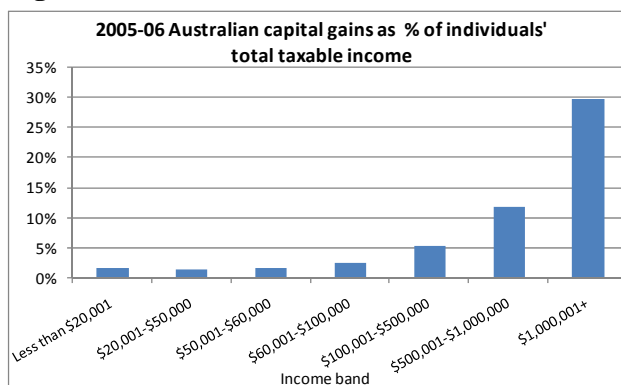
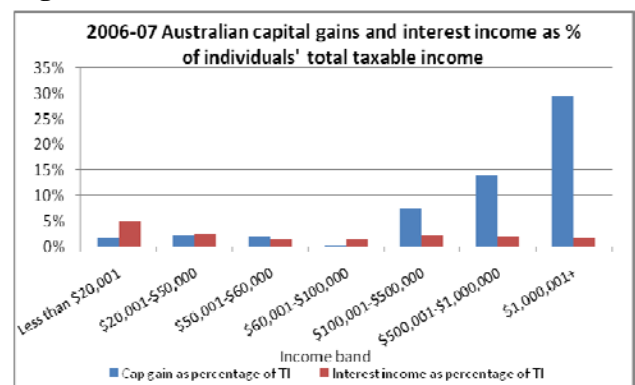


Figure 8

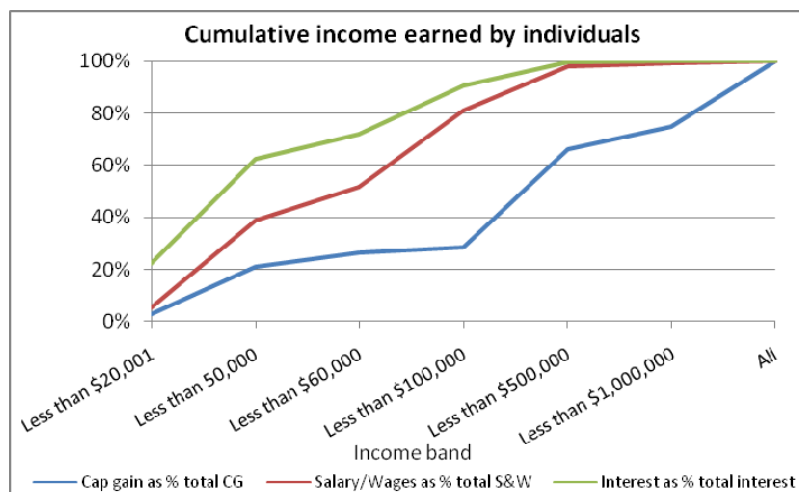


These graphs show that, as income rose, there was a steep increase in the ratio of capital gain income to total taxable income, with an associated increase in the ratio of tax burden to income. As with the US data, the profile is flat until about \$100,000 of income, when the proportion of capital gains to total income begins to rise steeply.

Thus, if the distribution of capital gain income and interest income in New Zealand follows a similar pattern to Australia, a CGT might be a way of financing cuts to higher marginal tax rates which would reduce disincentives to work and savings and increase tax integrity without necessarily reducing the progressivity of the tax system.

Figure 9 below shows a graph of three types of income earned by individuals on a cumulative basis. In essence, it shows the percentage of the total of each type of income earned up to certain income levels. The objective of the diagram is to portray how these types of income are distributed as income rises. The graph indicates that a bulk of interest and salary/wage income was earned by those on lower incomes, whereas the largest proportion of the capital gain income was earned by those at the upper end of the income spectrum:

Figure 9



If New Zealand displayed similar features to the features shown in Figure 9 for Australia, taxing capital gains would increase progressivity.

The New Zealand context

The analysis in this section is based on SoFIE. SoFIE includes information on individuals' and families' income, assets, and liabilities. Family information is used for this analysis as this is the best available proxy for household information.

In terms of considering the potential impact of a CGT in New Zealand, SoFIE sheds some light on how certain classes of assets are distributed across individuals and households in New Zealand. If capital gains are distributed in the same way as assets are distributed, SoFIE would provide an indication of how a CGT burden might fall on individuals and households. For more information on the SoFIE data, including its limitations, see Appendix 1.

Assets and liabilities in New Zealand generally

Provided below in Table 5 is an overview of household balance sheets for the period 2004-2008 based on aggregate data prepared by the Reserve Bank of New Zealand (RBNZ):¹⁵

¹⁵ As noted by the Reserve Bank of New Zealand, the estimates of household wealth do not include a number of items, such as: equity in farms, equity in commercial or unincorporated businesses, shares in unlisted incorporated businesses, direct ownership of assets such as forestry, consumer durables, and overseas property owned by New Zealand residents. It also does not include the value of human capital (Source: [http://www.rbNew Zealand.govt.nz/statistics/az/2989639.html](http://www.rbNewZealand.govt.nz/statistics/az/2989639.html)).

Table 5

\$New Zealand billions	2004	2005	2006	2007	2008
Total Household Financial Assets	154	165	188	199	194
Total Household Financial Liabilities	117	135	152	170	177
Household Net Financial Wealth	37	30	36	29	17
Less Student loans	7	8	9	10	10
Plus Housing Value	429	506	559	614	568
Household Net Wealth	459	528	586	633	575

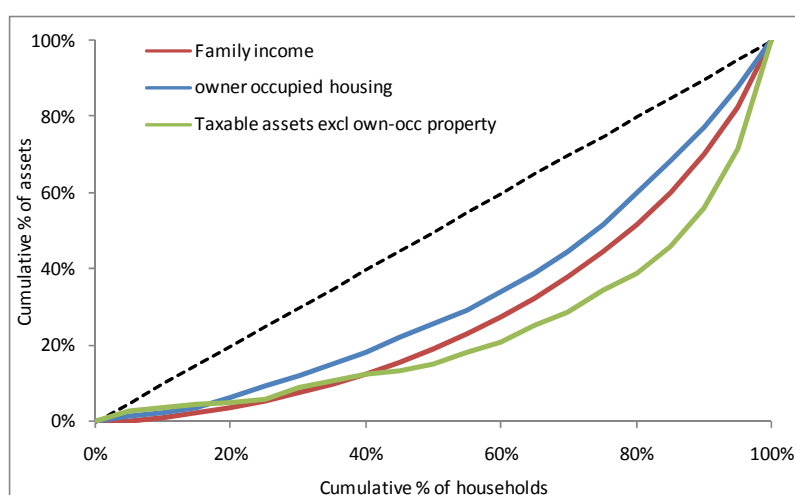
This table shows that a large part of household net wealth consists of the value of housing. This would make housing an important asset to consider when analysing the potential distributional impact of a CGT in New Zealand.

Real property distributions by income deciles

The relative distribution of real property assets can also be usefully demonstrated through *Lorenz curves*. This graphical representation shows the proportion of assets held by certain deciles of the population. In this distributional context, the aim is to provide an indication of the relative “fairness” of the spread of assets by comparing the actual spread of assets to how the distribution would look if the assets were evenly distributed (the black line in Figure 10). To illustrate, assets would be considered “equitably” distributed by net wealth deciles if 10% of the assets were held by the bottom decile of net wealth, 20% by the bottom two deciles, 30% by the bottom three deciles, and so on. The further the distribution line is from the black line, the more unequal the distribution of assets.

Figure 10 shows Lorenz curves outlining the distribution of family income, owner-occupied property, and all other assets (excluding cash in banks and life insurance):

Figure 10¹⁶



¹⁶ This includes zero values e.g. the whole population even if the individuals do not own owner-occupied property or investment property.

Owner-occupied property is the most equitably distributed real property asset in New Zealand, and Figure 10 shows that owner-occupied property is more equally distributed than family income. Other assets that may be subject to a capital gains tax (including superannuation funds, investment property, financial and business assets, and trust debts) are less equitably distributed than both family income and owner-occupied housing. Accordingly, to the extent that these asset types are subject to a capital gains tax, the progressivity of the tax system would be enhanced.

Other evidence regarding the distribution of real property across ethnic groups and age groups is provided as Appendix 2.

Figure 11 shows the mean value of real property and financial and business assets by family income deciles:

Figure 11¹⁷

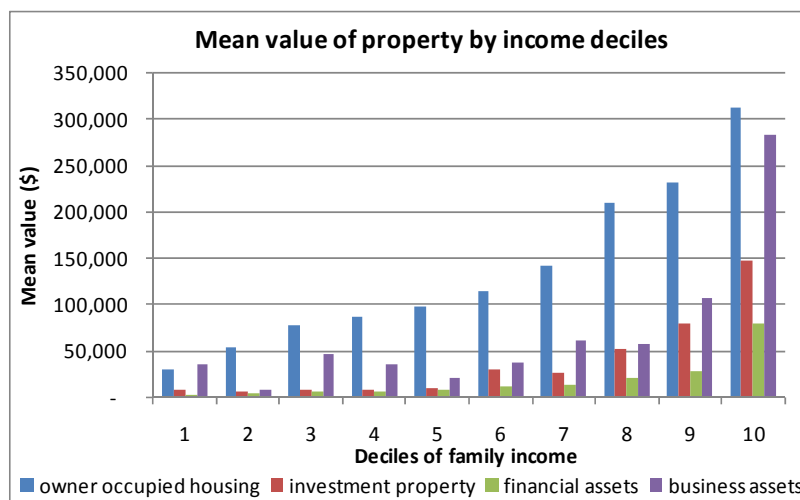


Figure 11 indicates that on average, owner-occupied property, investment property, and financial and business assets increase in value as family income increases, and that owner-occupied property has a significantly higher value at each decile than investment property or financial assets. Based on this data, were capital gains to be distributed in the same way as these assets, a CGT could improve the progressivity of the tax system as higher income families would be subject to a disproportionately larger share of the tax burden.

Figure 12 provides mean values for these property types by family income deciles. This graph differs from the previous in that the mean value of property by deciles excludes zeros and thus shows the mean value of the property for the individuals in that decile that own the particular type of property.

¹⁷ This includes zero values e.g. the whole population even if the individuals do not own owner-occupied property or investment property.

Figure 12¹⁸

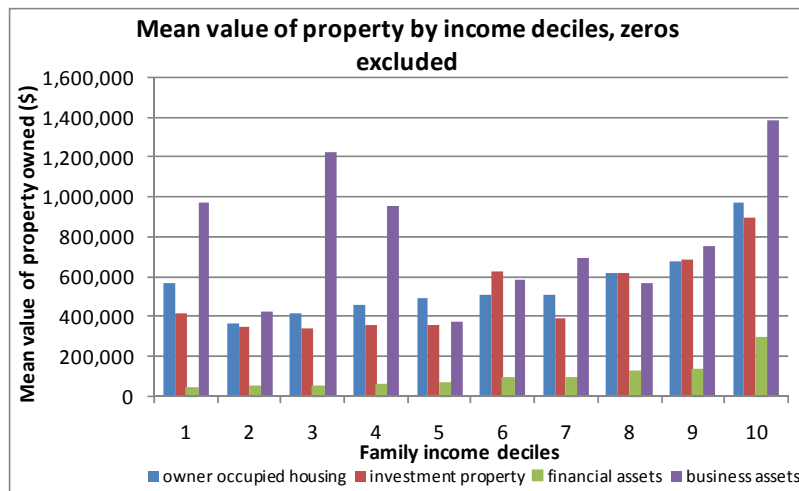
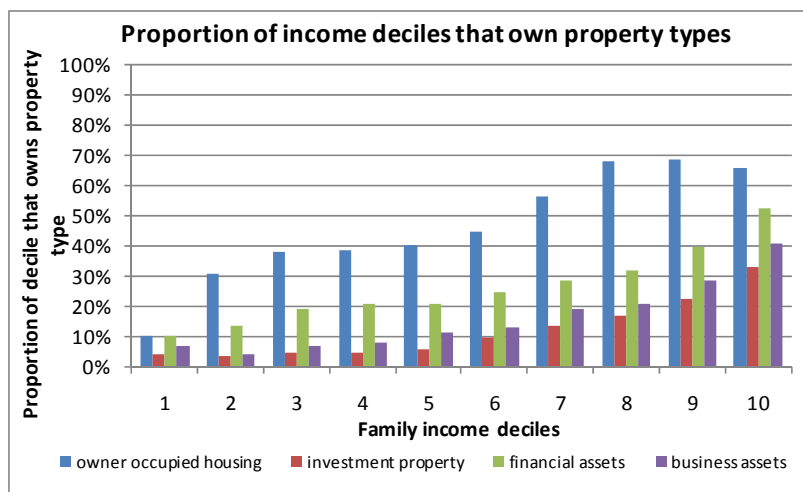


Figure 12 indicates that the mean value of owner-occupied property, investment property, and financial assets generally increases with increasing income deciles. When owned, business assets are higher in deciles 1 (possibly due to self-employment in this decile), 3, 4 and 10. Owner-occupied property has the highest value across most income deciles, with financial assets having the lowest value throughout the income deciles. If the distribution of capital gains followed a similar pattern, a CGT could well increase the progressivity of the tax system.

Figure 13 shows the proportion of each decile that owns each type of property, and demonstrates that the proportion of owner-occupied property owned in each decile significantly exceeds the proportion of investment property or financial assets owned. It also demonstrates that the proportion of ownership of investment property and financial and business assets increases across deciles. Owner-occupied property, while generally increasing, is flatter through deciles 2-6 than the other property types, and decreases from decile 9 to 10:

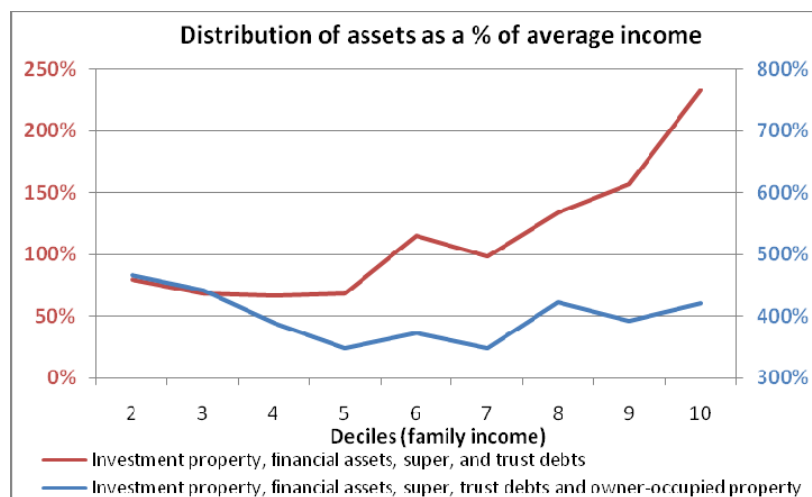
Figure 13



¹⁸ Does not include zeros. The median values shown in this graph show the median value of owner-occupied property and investment property where that property type is held by an individual.

Figure 14 shows the average value of investment property, financial assets, superannuation, and money owed by trusts owned by each decile as a proportion of that deciles' average income (the red line), as well as these assets and owner-occupied property, as a proportion of average income (the blue line). The red line demonstrates that the distribution of these assets, when measured as a proportion of income, is broadly progressive, and including gains on these assets in taxable income would increase the progressivity of the tax system. The blue curve in Figure 14 is less progressive, as the proportion of owner-occupied property's value to average income decreases as income increases:¹⁹

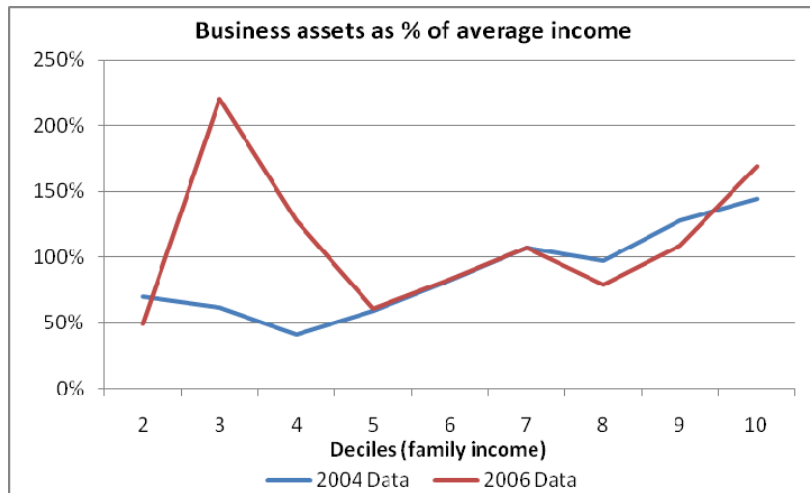
Figure 14



Ideally, Figure 14 would also include business assets in the assets measured as a proportion of income. However, these assets have not been included for two reasons. Firstly, the business asset category includes net business assets, whereas the other categories contain gross values, and do not include any liabilities attached to these assets. This makes comparison between the asset types difficult. Secondly, there is an apparent anomaly in the 6th vintile (which is reflected in the 3rd decile) with the business asset data, as the average value of the business assets in this decile are disproportionately high; and are the highest at any decile. This anomaly is unique to the 2006 data and is not reflected in the 2004 data. Figure 15 below shows the distribution of business assets as a % of average income in both the 2004 and the 2006 data:

¹⁹ Decile 1 has been excluded from Figures 14 and 15 because a large proportion of decile 1 families earn negative income, which skews the ratios shown in these graphs significantly.

Figure 15



What can be gleaned overall from the SoFIE data?

Overall, the SoFIE data indicates that the distribution of family’s real property and financial assets in New Zealand is highly skewed towards higher income families. However, as gains on different property types will vary, and may not be consistent across deciles of family income, the SoFIE data does not provide complete clarity as to how capital gains are distributed in New Zealand – nor does it provide certainty as to how the burden of a CGT would fall in New Zealand.

In appreciating markets it is possible that the distribution of capital gains will broadly follow the distribution of assets, and that the higher the base level of a person’s assets, the higher the associated capital gains are likely to be, thereby increasing that person’s income and potentially resulting in the application of progressively higher marginal tax rates. Where this occurs, it could be reasonably stated that a CGT would increase the progressivity of the tax system. Higher income families would bear a disproportionately larger burden of the CGT relative to lower income families.

CHAPTER 4

The current approach to taxing capital gains

Introduction

New Zealand does not have a formal capital gains tax but it does tax a number of capital gains under the current tax system. For example, certain land transactions, dealings in personal property (e.g. shares), financial instruments (through the financial arrangements tax rules), and intellectual property (e.g. patents) are all taxed to an extent.

However, New Zealand's current approach to taxing income from capital is inconsistent. This is resulting in the same form of income being taxed in different ways, at different rates, or not at all.

The current definition of statutory income bears little relation to the definition of comprehensive income. There is no attempt in the Income Tax Act 2007 ("the Act") to measure the change in an individual's net wealth and the level of consumption over the taxable period.

Rather, the Act taxes income by reference to the concept of ordinary income (Part C). The Act then extends this concept by legislating for specific forms of income, which may be either revenue or capital in nature.

Ordinary income

The Act contains an overarching provision that defines taxable income according to "ordinary concepts" (subsection CA 1(2)). However, the line between ordinary income and other income (i.e. non-taxable) is often unclear. Over the years, the courts have attempted to construct a boundary between the two by reference to whether the income is revenue or capital in nature. This is commonly referred to as the capital/revenue boundary. Receipts of a capital nature are exempt from taxation as a result of judicial decisions unless otherwise specifically legislated for in the Act.

Specific forms of income on revenue account

To clarify the concept of ordinary income and to provide rules for how such income is taxed, the Act contains extensive definitions of most types of income that fall within the concept of ordinary income (i.e. on revenue account).

An obvious example is the definition of amounts derived in connection with employment (e.g. salary and wages), which is clearly revenue in nature and therefore taxable as ordinary income.

A less obvious example is the taxation of share gains. Whether or not realised share gains are taxable depends on whether the seller of the share held that share on capital or revenue account.²⁰ This is often difficult to ascertain as the tax rules turn on whether the dominant purpose of acquisition was for resale. Often it is difficult to know and demonstrate with comfort what the dominant purpose of any particular share acquisition was (especially where there may be more than one purpose). The uncertainty is compounded where taxpayers buy and sell some shares for profit and buy others to hold for dividends (but later sell them). Further, identifying whether or not a number of share sales makes a person a trader is also an area of difficulty.

New Zealand has a relatively comprehensive company tax system. Companies are taxed on their income at the company level. The imputation system ensures that, by and large, income that is not taxed at the company level is taxed at the shareholder level if eventually distributed. Therefore, even without a capital gains tax, New Zealand's company tax system ensures that most of the returns to domestic shares are taxed to some extent.

Although the Act does not explicitly tax capital receipts from share gains, the company tax system and the concept of ordinary income may combine to ensure that in many instances the company earnings that contribute to share gains are taxed. However, shares can appreciate for reasons other than taxed accumulated earnings. IRD data shows that in general, public companies are not accumulating imputation credits. This suggests that generally, public companies are distributing all of their taxed earnings, so share price appreciation must be due to factors other than accumulation of taxed earnings.

Income from capital made explicitly taxable

Over time amendments have been made to the Act to supplement the definition of ordinary income to include specific forms of income that might be considered capital in nature. This incremental addition of capital income to the Act was referred to as the "pragmatic approach" by the Tax Review 2001.

The inclusion of specific forms of capital income in the Act generally occurs where:

- taxable income can easily be substituted for non-taxable capital gains;
- uncertainty exists as to whether income is revenue or capital; and
- there is a potential risk to the tax base.

²⁰ It should be noted that, in a New Zealand context, the capital / revenue boundary is only relevant to the sale of shares in New Zealand resident and Australian resident (and listed) companies. Large holdings of non-Australasian share investments are generally taxed under the fair dividend rate FIF rules.

These reasons for inclusion are not mutually exclusive. An obvious example is the ability for employers to substitute taxable wages for redundancy payments or restrictive covenants. Although such payments have now been made taxable, the ease with which employers could substitute taxable income for non-taxable income was a clear revenue risk. The uncertainty for taxpayers is not just determining which income is revenue and which is capital but also which forms of income in the future might be made taxable.

In addition to the revenue risk, the ability to shift income from revenue to capital account also creates economic inefficiencies by diverting investment to produce non-taxable income. These inefficiencies have been discussed in section 2. Distortions in investment decisions may also provide a policy rationale for bringing capital receipts into the tax base.

When income from capital has been explicitly legislated for, this can often result in complexity, inconsistency and uncertainty in the tax rules. Some examples are:

- Land. The existing tax law in respect of land is very complicated, with the application of tax turning on a number of factors, such as whether a person's purpose or intention in acquiring land was to resell it or whether or not the acquirer is a dealer in land, a developer, or a builder.
- Financial arrangements. Financial arrangements such as debt instruments and deferred property settlements are taxed on an accrual basis under the existing financial arrangements rules. Taxation on an accrual basis under the financial arrangements rules is in sharp contrast to the taxation (or non-taxation as the case may be) of other types of gains.
- Forestry. Forestry assets are currently tax preferred in that gains are not taxed until harvest/sale, whereas certain capital expenditures are either allowed upfront (e.g. seed/planting costs), or year to year (pruning; administration & accounting costs; interest). However, taxation of gains only occurs on realisation which is typically many years after the initial planting occurs, even though the gains have likely accrued (untaxed) over the intervening period. Relative to an instrument under the financial arrangements rules (where gains are taxed each year on an accrual basis) the tax preference may be very large.
- Shares. How shares are taxed may vary depending on whether the shares are in a New Zealand company, a listed Australian company, an unlisted Australian company, or another foreign company; and whether the shares are held by a portfolio investment entity, and, if not, whether they are held by a dealer or were acquired for the purpose of resale.

New Zealand is one of the few OECD countries that do not have a separate capital gains tax. Nevertheless, the Act does tax specific capital receipts. Although there is often a policy rationale for each instance in which capital gains are taxed, this incremental approach lacks an overall coherence and creates uncertainty for taxpayers.

Relevant reviews of the taxation of income from capital

In 1987, a Consultative Committee considering the accrual tax treatment of income and expenditure specified a strong preference for a comprehensive CGT, although they noted various difficulties in doing so.²¹ Also in this year the New Zealand Royal Commission on Social Policy concluded that there was an overwhelming argument for a tax on capital gains in terms of both fairness and efficiency.

In 1989, the Government proposed the taxation of capital gains including indexation of the tax base.²² However, the Government did not proceed with the proposals.

In 1998, a Committee of Experts was established to review aspects of the tax system, including tax compliance and avoidance/evasion issues. The Committee did not express an opinion on whether New Zealand should tax capital gains, but rather it pointed to issues of complexity associated with both taxing them and not taxing them.²³

In 2000, the OECD made two key recommendations for improvements to New Zealand's tax system:²⁴ consideration of the implementation of a comprehensive, realisation-based CGT; and taxing imputed rents.

The 2001 Review acknowledged that the current tax system does tax a wide range of capital receipts despite the absence of a separate capital gains tax. However, the two key capital assets excluded from the current tax base are certain shares and property.

It argued that, in principle, an accrual capital gains tax would be both efficient and fair. But such a tax is a "theoretical concept that can never be fully achieved under any real-world income tax".²⁵ A realised capital gains tax adopted by a number of OECD countries is problematic because due to:

- adds complexity to the tax system;
- encourages the deferral of gains and the acceleration of losses; and
- creates new problems such as defining the point at which an asset is "realised" and whether to provide rollover relief for the sale and purchase of similar assets.

On balance, the 2001 Review considered a realised capital gains tax did not warrant further consideration. Instead, the Review recommended continuing with the pragmatic approach of taxing capital gains if and when their exclusion from the tax base caused inefficiencies or revenue concerns.

²¹ Comprehensive Tax Reform and Possible Interim Solutions (1987, pp. 3-5).

²² "Consultative Document on the Taxation of Income from Capital" 1989

²³ "The Report to the Treasurer and Minister of Revenue by a Committee of Experts on Tax Compliance".

²⁴ "Economic Survey of New Zealand" OECD, 2000, p. 164.

²⁵ Tax Review 2001 Issues Paper, p.30, para 2.9.

In 2007, the OECD's Economic Survey of New Zealand recommended that New Zealand perform an assessment of two alternatives in terms of the strategic direction of the tax system: 1) a comprehensive income tax; and 2) a dual income tax (often termed a "Nordic" approach). Both alternatives effectively involve the taxation of capital gains, albeit with a lower rate under a Nordic approach.

CHAPTER 5

Options for taxing capital gains

Accrual basis capital gains tax

An accrual based CGT taxes the gain in an asset's value over a period with the tax payable at the end of the period (typically annually). On a first-principles basis, gains would be indexed for inflation so that only the real economic gain is taxed. Under accrual taxation, the tax liability arises regardless of whether the asset is disposed of. Declines in an asset's value would be treated as a deductible loss and immediately offset against other income or carried forward.

The accruals approach does not alter the relative after-tax rate of return from assets and, assuming full taxation at the same rate as other income, does not create a preference for investment in capital over other forms of income. Importantly, an accrual tax does not create incentives to bring forward losses and defer gains to exploit timing advantages.

Revenue from an accruals tax would be closely tied to the value of the capital stock in the economy. If the principle source of taxation were from real property and shares, fluctuations in the housing market and share market would be reflected in government revenues (i.e. government revenue would be more variable than at present and more pro-cyclical).

Valuation

An accrual capital gains tax would require a market valuation at the end of each period to identify the gain or loss. For widely traded assets such as shares, market values will be readily available at little or no cost.

However, for some assets valuations (even if they are possible) may be difficult and come at significant cost. Determining the value of a closely-held company or certain kinds of intellectual property (e.g. brands) could be an onerous exercise, particularly for small technology companies whose share gain may be based on intangible assets. Accordingly, under a full accrual approach, the compliance costs of holding certain assets may be significantly higher than for other assets. These costs would either have to be borne by the taxpayer or the government.

Intellectual property is another case in point. Identifying the cost base, its component parts, and its valuation at any given point in time (which are typically critical elements in the computation of any taxable gain²⁶ and its allocation to an income year) may be difficult.

²⁶ Although some of these elements are less important in the application of any risk-free rate of return method tax regime.

If valuation occurs on a specific date at the end of the taxable period, there may be scope for owners of seldom traded shares to manipulate the share value. If a sufficient number of shares are sold just prior to valuation at a below market price, this might reduce the share value so the owner has a lower tax liability.

Some authors consider valuation is less of a concern (e.g. Shakow, 1986²⁷). For example, in the New Zealand context, an accrual tax not only for assets such as listed equities but also for land might be feasible given the price data available on securities exchanges and the ability to use the local authority rating valuation system. A question would be whether or not this rating valuation system would be accurate enough for income tax purposes.

While there are some assets for which valuation will be straight forward on a regular basis, such as publicly-listed shares, there are others, however, for which data is not available or difficult to obtain without significant compliance costs. Thus, a comprehensive accrual-basis capital gains tax poses many practical challenges.

It might perhaps be possible to have a combined system with some assets being taxed on accrual and others being taxed on realisation but this would create some distortions and borderline problems. This is discussed further later.

Cash flow concerns

An accrual tax means taxing unrealised gains. This can cause problems where taxpayers invest in assets that do not produce a regular cash-flow to fund their tax liability. In some cases this may mean the asset will need to be partially or entirely disposed of to meet the tax liability, which may discourage investment in assets with substantial upfront expenses but longer term returns.

Employees remunerated through share schemes, for example, would be taxed each year on any increase in the value of their shares. To fund the tax liability employees could sell some of the shares. However, there may be “blackout” periods during which employees cannot sell shares in the company (e.g. close to the release of the company’s annual report) which might further constrain their ability to pay the tax.

In 1984 Canada offered taxpayers the option of being taxed on an accrual basis on publicly-listed shares. If they accepted, the gains were indexed to account for the recent high levels of inflation. A number of incentives to encourage taxpayers to adopt an accruals approach were provided, including tax on only 50% of the value of the asset and the ability to offset losses against other income. Take-up of the scheme was low and it was abandoned after one year.²⁸

²⁷ Shakow, D.J. (1986). “Taxation Without Realisation: a Proposal for Accrual taxation”. University of Pennsylvania Law Review 134: 1111-15.

²⁸ Italy also introduced accrual taxation for some important elements of capital gains in 1998. The reforms were abolished after only a few months.

To overcome the valuation and cash flow concerns, an accrual-equivalent tax has sometimes been suggested as an alternative. An accrual-equivalent tax is applied at the point of sale of the asset with an inbuilt interest component to account for the deferral of tax. In theory, this would have the effect of eliminating the deferral advantage of a realisation-basis tax, while managing taxpayers' cash-flow issues. However, an accrual-equivalent tax has its own problems, notably its complexity and its potential to increase lock-in effects in some instances.

Pros and cons

The key advantages of an accrual-basis tax are:

- the taxation of a closer approximation of economic income;
- neutrality with respect to investment decisions if applied to all assets at the same rate as other forms of income;
- no incentives to bring forward losses and defer gains; and
- more revenue generation potential.

The main disadvantages are:

- the regular valuation of assets;
- cash flow constraints from an annual tax liability;
- the perception that such a tax is unfair; and
- greater revenue volatility for the government.

A comprehensive accruals-based tax is theoretically the most efficient approach to taxing capital gains. While valuation may not be an issue for a large proportion of the assets that make up the asset base (i.e. shares and land), it may be impossible to value some assets. This rules this option out. However, an alternative may be to tax on accruals those assets that can be valued and to tax on realisation those that cannot. Such a hybrid approach does create its own set of problems, which are discussed later in this section.

Realisation-basis capital gains tax

If valuation and cash flow are major drawbacks to an accruals capital gains tax, an alternative is to tax an asset when it is sold. In this case the taxpayer will be able to fund the tax liability with the proceeds and taxation is based on the market price of the asset. If the sale price is less than the cost base, the taxpayer realises a loss which may be offset against other income or carried forward.

A realisation-based CGT is generally simple to understand and is employed in a number of ways within the current system (e.g. the revenue account property provisions). It also has the benefit of not creating cash-flow issues, as the tax liability only crystallises on sale (where the gain is available to fund it).

A realisation-basis tax, however, has some disadvantages not least of which is the incentive to defer the sale of appreciating assets and bring forward the sale of depreciating assets. Two issues emerge from this behaviour. First, taxpayers may be “locked-in” to holding long-term assets that appreciate. Second, if losses from capital assets can be offset against other income, taxpayers may choose to sell depreciating assets early to reduce minimise future tax liability. As with any capital gains taxation, these effects will be very different depending upon the type of asset.

Lock-in

The incentive for an owner to defer the sale of an asset increases with:

- The rate of tax. The higher the rate, the greater the cost of disposing of the asset.
- The rate of appreciation. The taxable gain will be greater after sustained periods of appreciation when the asset is eventually sold.
- The extent to which the asset can be substituted for another asset. A tax at sale will discourage switching one asset for a similar asset (e.g. a share swap).

It is not surprising, therefore, that estimating the degree of lock-in from a capital gains tax is both difficult and would be expected to vary across assets.

To consider how important lock-in is likely to be, it is worth working through a simple example. Suppose that a taxpayer faces a 30 percent tax rate and is taxed at this rate on both ordinary income and on realised capital gains. The investor has an asset (a share) which was acquired for \$100 which is now worth \$200. Suppose that by retaining the investment for a year, the investor will generate a 10 percent return. This consists of a \$20 gross dividend. We assume that the share is expected to maintain its current price of \$200 with no further expected appreciation. If the investor sells up at the end of the year, he or she will have revenue of \$220 but tax of \$36 (i.e. \$120 multiplied by 30 percent). This leaves after-tax revenue of \$184.

Suppose, instead, that the investor sells the initial share immediately for \$200 and reinvests the after-tax proceeds. This will leave \$170 to invest (i.e. \$200 minus \$100 multiplied by 30 percent). Suppose that the investor chooses a second share which also provides a gross dividend of \$20 and is expected to maintain its current price. If the investor sells up at the end of the year, he or she will have revenue of \$190 minus a tax liability of \$6 (i.e. \$20 multiplied by 30 percent). This once more leaves \$184.

While the first share provided a 10 percent pre-tax rate of return (\$20 divided by \$200), the second needs to provide an 11.8 percent pre-tax rate of return (\$20 divided by \$170) to leave the investor as well off. Lock-in arises because the replacement asset needs to generate a higher pre-tax rate of return to leave the investor as well off.

Table 6 below shows the rate of return on replacement assets as a function of possible rates of capital gains tax (rates of 30 percent or 15 percent are assumed) and as a function of the gain as a proportion of the initial value of the asset. A gain of 0 means that the original asset has not appreciated. A gain of 1 means that it has doubled in value and so forth.

Table 6 Rate of return on replacement asset – existing asset generating 10%

	0	1	5	infinite
Tax rate = 0.3	10%	11.8%	13.3%	14.3%
Tax rate = 0.15	10%	10.8%	11.4%	11.8%

As has been noted in section 2, leaving owner-occupied housing out of the tax base would tend to increase current tax biases favouring owner-occupied housing and increase deadweight loss. However, including owner-occupied housing would tend to create lock in. The effect that this might have on labour mobility is perhaps a particular potential concern with a realisation-basis capital gains tax.

Burman and White (2003) noted the available literature indicates that lock-in may not be as much of a problem as economists and accountants tend to believe. For example, if lock-in was a significant issue, then asset realisations would be very sensitive to the rate of tax. However, the results from time-series studies performed in the US found that gains were not very sensitive to tax rates (Auerbach, 1989). Work by Burman and Randolph (1994)²⁹ considered how individuals respond to permanent and temporary changes to the tax rate on capital. The findings indicate that permanent changes in capital gains tax rates may have little or no effect on realisations, whereas there may be a large response to temporary rate changes.

Roll-over relief

A number of countries have introduced “roll-over relief” which allows the tax-free sale of assets where the same or similar assets are purchased.³⁰ In Australia when a taxpayer exchanges shares in the same company or units in the same unit trust, roll-over relief is granted.

Roll-over relief can help prevent inefficiencies occurring due to lock-in effects. However, roll-over does not completely resolve lock-in because of the incentive to continue to invest in similar assets for which relief is available.

²⁹ Burman, L. and Randolph, W. (1994). “Measuring Permanent Responses to Capital Gains Tax Changes in Panel Data”. American Economic Review 84: 794-809.

³⁰ NZ has a limited form of rollover relief for the disposal of property under the will of a deceased person to the surviving spouse. The transfer of ownership is not taxed.

Other countries have introduced lower rates that help mitigate the effect of lock-in. Australia has both a lower tax rate on capital and specific exclusions such that only a portion of the gain is subject to tax. Assets held by individuals for more than one year, for example, are taxed on only 50% of the value of the asset (effectively halving the tax rate).

There will be some instances where roll-over relief is clearly appropriate. For example, where the sale of the asset is not within the control of the owner of the asset (e.g. a shareholder issued new shares following a merger). However, where an asset is sold and replaced with a very similar asset (e.g. a business moving to new premises) it is not obvious roll-over relief should be allowed. The situations to which roll-over relief would apply require further analysis.

Losses

Taxing on a realisation-basis creates a bias towards long-held assets and an incentive to bring forward losses. This feature has prompted many countries to allow losses from assets only to be offset against capital gains and not other forms of income (referred to as “loss ring-fencing”). The losses could, however, be carried forward and offset against future capital income. Without loss ring-fencing, a taxpayer could sell a loss-making asset at the end of the year and offset the loss against the tax liability of appreciating assets that may not be sold until much later. This problem does not arise under an accruals-based tax.

Internationally, symmetric treatment of capital gains and capital losses is not generally provided. Most OECD countries tax capital gains on disposal, while restrictions usually apply in relation to the use of capital losses. As reported by the OECD, “...some but not all OECD countries allow excess capital losses to be deducted against interest income, with fewer still allowing excess capital losses to be set off against non-investment (i.e. ordinary wage) income....while carry-forward (and in some cases carry-back) provisions are offered by a number of countries, generally one or more restrictions apply....”³¹

In Australia, for example, individual taxpayers are required to include any net capital gain income (capital gains less capital losses) in their assessable income, which will be taxed at the taxpayer’s marginal tax rate. However, while any excess capital losses of an individual may be carried forward indefinitely, no capital losses may be used to offset against other income of the taxpayer.

In the US, capital losses are generally deductible against capital gains, but up to USD\$3,000 excess capital losses may be deducted against other income of the individual. As in Australia, unused capital losses in the US may be carried forward for future offset. From OECD survey evidence, it is clear that most countries that comprehensively tax capital gains have some form of loss ring-fencing (i.e. loss restriction) provisions.

³¹ OECD Tax Policy Studies, *Taxation of Capital Gains of Individuals Policy Consideration and Approaches*, OECD 2006.

Loss-ring fencing could possibly be a necessary feature of a realised capital gains tax to prevent the erosion of the tax base.³² However, the design could be relevant. Loss limitation is less necessary if capital gain income is taxed at ordinary rates, then the tax relief of losses could also be provided at ordinary rates, reducing the need for a limitation. Also, if a capital gains tax applied on accrual, there would be less need for limiting losses as the timing of recognising losses and income could not be manipulated. An advantage of having no loss limitation would be the elimination of any need to have a capital/revenue boundary and its complicated tests.

For taxpayers who own a wide range of assets, loss-ring fencing may not be an issue. The losses from assets that under-perform or are not expected to return income for some time would be offset against gains from other assets. However, loss ring-fencing may disadvantage taxpayers that own one or few assets, such as a business that may not be profitable in the early years. In this respect, loss ring-fencing may discourage investment concentrated in one particularly risky project where any gain is taxed but any loss non-deductible.

Restricting capital losses may create a new boundary between the treatment of losses from the disposal of assets on revenue account and those made on capital account. Losses from the sale of trading stock, for example, would be deductible against all other income from a business. However, the sale of land by a business would not.

While it is likely that the restriction of capital loss deductibility will have an impact on risk-taking at the margin, given the revenue risks of not restricting losses, it is likely to be fiscally prudent to have some rules in place. If the capital gains tax applied at ordinary rates and on accrual the need for limiting losses may be less urgent.

Sale of an asset

The incentive to bring forward losses and defer gains may mean that restricting losses to capital assets may not be sufficient to prevent the manipulation of the timing of realisation. Rules may be required to prevent companies disposing of loss-making assets and repurchasing the same or similar assets soon after (i.e. a wash-up sale). Most countries have rules where they will not recognise capital losses if an asset is purchased and sold within a specific time period. Where such transactions take place, the losses are only recognised when the new asset is on-sold. To apply such rules would mean clearly defining an asset which is the “same or similar”. Rules would need to be developed to provide some minimum level of protection of the capital gains tax base.

³² To prevent the buying and selling of corporate capital losses, excess capital losses of a company could be made subject to a shareholder continuity test (such as that applying to ordinary company tax losses currently). This would mean that companies would not be able to carry-forward capital losses for offset against capital gains earned in future years unless substantially the same shareholders had majority ownership (based on voting interests) of the company in the period from the start of the capital loss year to the end of the capital gain year. Consideration could also be provided to allowing the transfer of capital losses between companies within a tax group (e.g. a consolidated tax group).

Another issue to consider is where a taxpayer is taxed on the gain from a significant asset in one year. This may result in the taxpayer facing a much higher average tax rate relative to their average tax rate in prior years. To overcome this problem in Australia, the tax rate of one fifth of a taxpayer's income from capital is applied. For example, assume a taxpayer sells an asset and realises a gain of \$100,000 in one year. The capital gains tax on one fifth of \$100,000 (i.e. \$20,000) is calculated. This tax liability is then multiplied by five to arrive at the final tax liability for the taxpayer. This provides a more accurate reflection of the taxpayer's tax rate as if they had been taxed on the gains on an accrual basis. However, it appears it would increase complexity and compliance costs.³³

Pros and cons

The key advantages of a realisation-basis tax are the:

- ability of taxpayers to fund the tax liability;
- the existence of a sale price for determining the gain or loss;
- relative simplicity of the concept for taxpayers; and
- relatively lower revenue volatility than a tax on accrual-basis.

The main disadvantages are the:

- the incentive to defer the sale of appreciating assets (lock-in) and bring forward the sale of depreciating assets;
- the associated complexity with roll-over relief; and
- need to restrict capital losses to income from capital gains and the boundary this creates.

Hybrid accruals/realised

An alternative approach is to tax on realisation those assets where valuation and cash flow are a problem and tax on an accruals basis where they are not. Real property is likely to have both valuation and cash flow problems and, as such, would be taxed on realisation.

There would not, however, be any problems regularly valuing publicly listed shares. However, taxing listed shares on accrual basis may create an incentive for companies not to list and a preference by investors for unlisted shares. The accrual tax treatment is not likely to affect the listing of large listed corporates. Rather, smaller listed companies may consider taxation on a realisation-basis a sufficient incentive to delist.

³³ Australia has since repealed this policy. It was introduced as a way of dealing with fiscal drag.

A consequence of this preference to delist might be the emergence of private equity investment funds that specialise in the brokerage of smaller unlisted companies. The preference to delist could be reduced or eliminated by a proxy measure for accrued gains in unlisted companies, such as a deemed rate of return on capital invested.

Shareholders that have a major holding in a company may find themselves having to fund significant tax liabilities if taxed on accrual. This might be of particular concern to shareholders that hold 51% of the shares in a company and who would be reluctant to sell to fund the tax.

CHAPTER 6

Issues common to all types of capital gains tax

Whether an accrual or realisation-based capital gains tax is under consideration, there are a number of substantial design issues that would need addressing. However, OECD countries that have introduced a realised capital gains tax have designed rules to cope with these problems. On their own, these issues would not provide a case for rejecting a capital gains tax.

The double taxation of income from shares

A realised capital gains tax on corporate income could lead to an element of double taxation. For income taxed at the company level, there could be an element of double taxation if firms had not distributed this income and if the retained earnings were reflected in higher share prices and gains in shares were being taxed on sale.

The question is if a capital gains tax were implemented, would double taxation be a concern? The company may still hold imputation credits that have some value. However, there is no interest earned on these credits and their value will depend upon the ability to use the credits at some later date. An outcome to avoid is one where the tax treatment of shares relative to dividends discourages a company from retaining and reinvesting profits. Superannuation funds faced a similar issue with respect to taxable gains from share trading prior to the exemption for capital gains under the PIE rules.

Allowing imputation credits with bonus share issues is one method for companies to effectively distribute without reducing their retained earnings.

There could be ways of adapting the imputation system to relieve double taxation on share sales, although it is likely to do so imperfectly and increase compliance costs. For example, Norway used to have a system called RISK which was later removed when Norway repealed its imputation system. Simply deeming imputation credits to be distributed to all shareholders who held shares for some or all of the year, and not attaching them to particular dividends, could be an approach to consider.

Exemption for owner-occupied housing

Although in principle all property should be included in the capital gains tax base, many countries either exempt a person's primary residence or provide some form of concessionary treatment. However, there are problems with concessions in respect of owner-occupied housing:

- Full primary dwelling exemption. The concern with exempting the primary dwelling is that it creates a bias towards investment in one's own home relative to other forms of investment, particularly since the land is expected to appreciate in value. Exemption adds to the existing bias caused by the non-taxation of imputed rents. As around two thirds of residential homes are owner-occupied, the reduction in potential tax revenue from a capital gains tax may be significant. There could also be issues around determining which property was the actual primary dwelling, where there was more than one dwelling used by the taxpayer.
- Allow roll-over relief until owners downsize. Roll-over relief would mitigate the effects of lock-in. Although rules would need to be developed to define "downsizing", this option has the benefit of only taxing gains on owner-occupiers when cash flow is less of an issue.
- A threshold under which capital gain on a principal residence is not taxed. For example, the United States exempts the first \$250,000 of gain on the sale of a principal residence from tax. This excludes almost all home sales from the tax, but some tax still applies if the gain is very significant.

Omitting owner-occupied housing from the capital tax base creates inefficiencies yet the lock-in effects from its taxation might be significant. Allowing roll-over relief is a possible approach to reducing lock-in.

Indexation

Ideally, any taxation of capital would exclude increases in both gains and expenditure due to inflation. Indexation under a realisation-basis tax provides a closer approximation of real economic income and it reduces the lock-in effect.³⁴ However, there are a number of drawbacks, notably:

- Complexity. If additions to assets are made over time indexation would have to be calculated on different cost bases. For example, a fund manager purchasing and selling many shares on a daily basis would have to track different indexed cost bases over time for each share.
- Arbitrage opportunities. Unless applied to expenses and all other forms of income, indexation encourages investment in capital over other forms of income (for example, where nominal interest is fully deductible but capital assets are taxed on a real basis). The absence of indexation can result in an investor generating a pre-tax loss but an after-tax profit.
- Fairness and efficiency. If capital gains are indexed, arguably all other forms of income should be also.

³⁴ As noted by Gravelle (1994) and Burman (1999), indexation could also reduce the impact of any lock-in effects under a realisation basis, due to a lowering of the overall effective tax. Gravelle, J. (1994). "The Economic Effects of Taxing Capital Income". Cambridge: The MIT press. Burman, L.E. (1999). "The Labyrinth of Capital Gains Tax Policy, a Guide for the Perplexed". (Washington, D.C.: Brookings Institution Press).

Australia repealed indexation in 1999 because of the high compliance and administrative costs. The repeal was offset by the introduction of exclusions for some assets (e.g. a 50% discount applied for assets held by individuals for more than 12 months). In practice, the alternative of excluding a portion of the capital gain from taxation to compensate for inflation does not have the complexity of indexation and may also reduce lock-in. Indexation invariably creates complexity. Further, other forms of taxable income are not indexed.

If a capital gains tax were implemented, the Group may wish to consider whether indexing gains is preferable.

Death and migration

If lock-in under a realisation-basis tax is an issue, how capital gains are treated at death and migration will be important. Lock-in is greater the longer the period for which the asset is held. There are two approaches to treating capital gains at death:

- Deem sale at death. The asset must be valued and the estate pays the tax. There are no lock-in effects because the asset has been effectively sold. But the estate must fund the tax liability which may be particularly difficult for a long held asset that is not actually sold.
- Carryover. Ownership of the asset is taken over by the estate. Either the original cost basis is used and the capital gains liability is inherited by the estate or the market value at the time of death is used as the new cost basis for the estate. The original cost base may create severe lock-in effects if the asset has been held for a long period and will continue to be so. However, there is no need for the estate to fund an immediate tax liability. The market value base effectively forgives the tax liability (which will reduce the revenue collected).

Obviously, whether owner-occupied housing is excluded from the capital base will be a critical issue given that housing is typically held for long periods during which it appreciates in value.

The treatment of migration also raises issues. If no tax is imposed when a person migrates (terminates tax residence) then migration may be a simple way to avoid tax on appreciated assets. In fact, it could create an incentive to migrate. An alternative would be to deem a disposal upon migration. This would create a lot of compliance costs in a year of migration and it also raises practical issues of enforcing the tax after the taxpayer has moved from the country.

Transition

There are two ways to transition to a realisation-basis capital gains tax. Assuming that it is undesirable to retrospectively tax gains and losses from assets made prior to the introduction date, the new tax may apply either to:

- gains and losses from assets *acquired after* the date of introduction (i.e. “grandfathering”); or
- only gains or losses accumulated after introduction date from assets *held on or acquired after* the date of introduction (“valuation day”); alternatively deem the tax cost basis to be the higher of the value on implementation date or the cost of the asset; or
- apply a valuation day to those assets that are easy to value and grandfather all other assets.

If the tax only applies to assets acquired after implementation date, all gains from existing assets will be exempt until they are sold. Although this approach may make the transition easier for taxpayers and administrators alike, it would:

- aggravate the lock-in effect by discouraging the sale of existing assets;
- favour existing assets over and new ones; and
- reduce revenue.

Lower revenue estimates would have to reflect the length of time it would take for all assets to come within the capital base. For significant long-held assets, this may be some time. Australia introduced a capital gains tax in 1986 and there are still assets that have yet to be sold and taxed since that year.

Alternatively, the past gains and losses must be calculated and subtracted from the base if the tax applies to existing assets. A “valuation day” would involve an owner of an asset providing a market price for the asset which becomes the new cost base for the asset in future. Valuation day is equivalent to assuming all assets are “sold” on the date of introduction (except no tax is collected).

Some assets, such as shares in private companies, will be difficult to value and the compliance costs might be a considerable burden for some taxpayers (e.g. small technology companies whose value relies largely on their intellectual property). Valuation day also creates incentives for taxpayers to inflate the value of their assets to reduce the future taxable gain.

Deeming the tax cost basis to be the higher of original cost or value on valuation day ensures that no one is overtaxed. However, it would allow taxpayers to deduct capital losses that accrued before the regime came into effect.

From an efficiency perspective, the valuation day approach is preferred because it brings all assets within the capital base as soon as possible. However, such an approach might have to consider alternative rules for assets that are hard to value.³⁵ Grandfathering is more realistic where valuation is a problem.

Administrative issues

A capital gains tax will have a number of administrative implications. The precise implications will be driven from the specifics of design. Broadly, some of the most immediate implications of a capital gains tax are the need for:

- More taxpayers to file returns. A capital gains tax would bring some taxpayers (e.g. salary and wage earners) back into return filing, increasing administration costs in terms of processing these returns.
- More guidance and tools for taxpayers. IRD will need to develop a CGT guide for taxpayers and calculation tools to assist in performing computations. Where indexation is required, IRD will need to maintain and publish an index (or indexes).
- Changes to tax returns forms and Inland Revenue's tax return system (FIRST) to accommodate. This would require significant additions to Inland Revenue's systems to incorporate the new capital gain income line item in tax returns (and possibly capital loss carry-forward line item).
- Increased audit responsibilities.
- Consideration of the administration implications of volatile incomes for calculating and delivering social assistance, including the calculation of child support liabilities, student loans eligibility and entitlement to Working for Families.

Given the scope of the necessary changes, it is likely that a realisation-based capital gains tax will increase the complexity of the tax system.

Other issues

There are a wide range of issues to consider in the design of either an accrual or realisation-basis capital gains tax. Those discussed so far have been the significant ones. The remaining issues require substantial development; however countries with a capital gains tax have successfully managed to design appropriate rules. Some examples of these issues are:

³⁵ The Consultative Document on the Taxation of Income from Capital (1989) considered the use of the "time apportionment" method for assets which are difficult to value. Essentially, this method measures the accrual of the income or loss from the sale of an asset on a straight line basis and use this calculation to estimate how much of the gain or loss occurred before implementation date.

- The definition of an asset. Although defining what assets will be taxed will be evident in many cases, whether items such as goodwill, intellectual property and options are assets may be less clear.
- Disposal of an asset. The 2001 Review referred to the example of a leased asset and questioned how long a lease must be before part or all ownership of the asset is effectively transferred to the lessee.
- The treatment of non-residents. Where possible the rules that apply to current taxable income should also apply to capital gains (i.e. taxing income that is sourced in New Zealand). There may be some practical constraints to taxing gains from movable property which require relaxing this rule.
- The interaction between capital gains and social assistance. If capital gains are taxed, the question arises as to whether such income should be accounted for when determining the level of social assistance.

CHAPTER 7

Revenue implications

We estimated the potential revenue by doing a high level analysis of the likely revenue to be generated from the assets most likely to produce revenue – land and shares.

The following table illustrates projected revenues from capital gains taxes applied to land and shares assuming those assets continue to appreciate at their historical real rates, and inflation is 2%.

Asset category	Base value	Assumed appreciation rate	Assumed tax rate	Revenue
Individual investment property	\$120.3 Billion ³⁶	4.2% ³⁷	28.5% ³⁸	\$1.4 Billion
Commercial and industrial property	\$123.0 Billion ³⁹	2.6% ⁴⁰	30% ⁴¹	\$1.0 Billion
Rural property	\$134 Billion ⁴²	5.4% ⁴³	25% ⁴⁴	\$1.8 Billion
Subtotal – real property other than owner-occupied housing				\$4.2 Billion
New Zealand and Australian shares held by managed funds and life insurers				\$161 Million ⁴⁵
New Zealand shares held by households	\$11 Billion ⁴⁶	2.6% ⁴⁷	33%	\$94 Million
Foreign shares				\$51 Million ⁴⁸
Subtotal – equities				\$306 Million
Subtotal base excluding owner-occupied housing				\$4.5 Billion
Owner-occupied housing	\$447.7 Billion ⁴⁹	4.2% ⁵⁰	24.7% ⁵¹	\$4.6 Billion
Total including owner-occupied housing				\$9.1 Billion

³⁶ \$568 Billion is the total housing stock as at 2009 (quarter 1 of Quotable Value and RBNZ data). This housing stock is then multiplied by the value of individually-owned investment property as a proportion of total residential property according to the SoFIE data, which is approximately 21%. This gives an individual investment property tax base of \$120.3 billion.

³⁷ 2.2% average real appreciation rate from June 1962 to September 2004 per QV quarterly house price index, plus 2% inflation.

³⁸ Weighted average marginal tax rate of individuals owning investment properties per 2006 SoFIE data.

³⁹ 2006 capital value per table 5.1 in the Coleman and Grimes paper on land and property taxes.

⁴⁰ 0.6% average annual real appreciation rate for commercial property from June 1986 to June 2004 per QV index plus 2% inflation.. As the split of capital values between commercial and industrial properties is not known, estimate is based on the index with the lower appreciation rate (commercial property).

⁴¹ Company tax rate assumed.

⁴² 2006 capital value per table 5.1 in the Coleman and Grimes paper on land and property taxes.

⁴³ 3.4% average annual real appreciation from June 1980 to June 2004 per QV rural price index plus 2% inflation.

⁴⁴ Rate assumed to be 30% (company rate) for profitable farms, adjusted to a lower rate to account for some farms in loss.

⁴⁵ Revenue estimate obtained by adjusting previous revenue estimates made for PIE reform.

⁴⁶ Per 2008 Reserve Bank Household financial assets and liabilities survey.

⁴⁷ 0.6% average real NZ sharemarket capital value index appreciation from 1981 to 2008 plus 2% inflation.

⁴⁸ Revenue estimate derived from adjusting estimates made in implementing fair dividend rate regime.

⁴⁹ \$568 Billion total housing stock less investment property.

⁵⁰ 2.2% average real appreciation rate from June 1962 to September 2004 per QV quarterly house price index, plus 2% inflation.

⁵¹ Weighted average marginal tax rate of individuals owning their home per 2006 SoFIE data.

Appreciation rates were taken from QV indexes for real property and NZX and other share market capital indexes for shares. Appreciation rates were taken for the longest possible period up to the most recent valuations. In the case of real property, the index was taken for the longest period up to the most recent valuation or up to September 2004 if less, as QV changed its index methodology at that time in a way which may not have controlled for changing quality of stock as well as the earlier methodology.

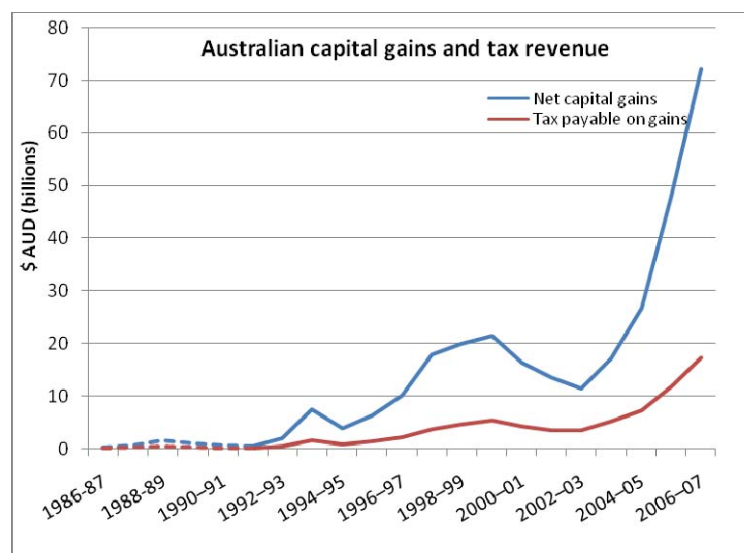
The revenue estimate was calculated by forecasting the tax on capital gains as they accrue. A realised capital gains tax would earn something near this but less than this (even after accounting for the fact that realised gains may include multiple years of appreciation).

The total forecast revenue should be reduced by amounts we tax now as disposals of revenue account property that are included in the above table, such as real property. Unfortunately, we do not have the information to make that adjustment.

It should be noted that the revenue estimate is highly sensitive to the assumed appreciation rate. A one percentage point change in the assumed rate of appreciation of real property results in an approximately \$1 billion effect on revenues. It also appears that in many cases most of the expected appreciation is the result of inflation.

Significantly, this estimate does not account for the effect of any transition. If existing assets are grandfathered it could take some time before a large asset base is subject to the regime. Australia introduced its capital gains tax from 1985/86 and grandfathered existing assets. The following graph shows how it took about 15 years after introduction before revenues peaked, and it also shows how volatile the revenues are even after 15 years.

Figure 16⁵²



Given that it is difficult to predict future market volatility, it may be reasonable to assume that a New Zealand capital gains tax with grandfathering would take about 15 years to produce its full level of revenue.

⁵² The dotted lines represent years where we have incomplete data on net gains and/or tax paid.

APPENDIX 1

The SoFIE data

One of the best empirical tools policymakers in New Zealand currently have to aid in analysis is the Survey of Family, Income and Employment (SoFIE). It covers ownership patterns, debt, net equity, and the composition of household portfolios. SoFIE collects data on the levels, sources, and changes in income for individuals and families in New Zealand. It also provides information on the major influences on income, such as employment, household changes, and demographic factors. Over 29,000 individuals from 11,500 households agreed to participate in SoFIE in October 2002, representing 3,939,000 people. The original sample members are tracked and surveyed annually with the last wave planned to go into the field in October 2009.⁵³ It is considered a highly valuable source of basic data for a wide range of economic, social, health, financial, and investment analyses.

Assets and liabilities – SoFIE data

SoFIE includes assets and liabilities attributable to individuals and families. It does not provide reliable information on assets held in trusts of which the individual or family is a beneficiary; and also does not provide reliable estimates of the assets held by a company (the shares of which are owned by the individual or family). However, to the extent an individual or family is in the process of gifting assets to a trust (and is still a creditor of the trust because the gifting programme hasn't been completed) an asset will be attributed to the individual or family.

As noted by Scobie and Henderson (2009),⁵⁴ assets and liabilities in SoFIE are classified as follows:

*Assets:*⁵⁵

- **Property assets*** in five classes: owner-occupied housing; rental property, other residential property (including land), timeshares, overseas property;
- **Bank account assets;**
- **Financial assets*** in two classes: financial investments in unit trusts or funds, financial investments not in unit trusts or funds;

⁵³ Note that the sample used for the capital gains tax analysis is different again. Data from wave 4 was used to provide the underlying distribution of assets. By wave 4 (2006), some people had dropped out of the survey but the weights of those responding were increased to compensate. The distribution of assets was based on data from about 17,500 individuals who were 15+ and not dependent children. The number of people represented by this group was 3.07 million.

⁵⁴ Scobie, G. and Henderson, K. (2009). "Savings Rates of New Zealanders: A Net Wealth Approach". New Zealand Treasury.

⁵⁵ Assets that have an asterisk have been included in our analysis.

- **Life insurance assets** in three classes: bonds or investment-linked policy, whole of life or endowment policy, other types of life insurance policy;
- **Superannuation assets*** in two classes: employee-related super scheme, other personal super scheme;
- **Net business assets*** (impossible to disaggregate but includes business or business investment, equity in farms, orchards, vineyards, forests, commercial property);
- Outstanding **assets owed by a trust*** to which assets are being gifted;
- **Durables** in three categories: household items, vehicles, leisure equipment;
- **Other assets:** cash, art or antiques and collectables, and miscellaneous.

Liabilities:

- Mortgages;
- Personal bank or finance company loans;
- Student loans;
- Bank account liabilities;
- Net business liabilities;
- Credit card debt;
- Hire purchase debt;
- Other debt.

Information limitations

There are a number of issues that one needs to be cognisant of when using the SoFIE data:

- The SoFIE data on assets is aggregated to such a degree in many areas that the holdings of most specific assets cannot be separately identified. Examples of assets that cannot be separately identified include: shares and specific types of business assets. In reality the best information SoFIE can currently provide for the purposes of considering the potential distributional impact of a CGT in New Zealand is in relation to the distribution of real property assets of individuals and families. In many cases we have also included financial assets (other than bank accounts) on the assumption that these will include shares that may be subject to a capital gains tax.
- SoFIE collects detailed data on assets and liabilities in alternative waves. The years for which asset and liability data are currently available are 2004 and 2006, which was arguably nearing the peak of the real property market. Given the analysis is forced to focus on this asset class; this factor should be borne in mind.

- The SoFIE data provides information about assets and liabilities held at the individual and family level. Accordingly, it does not include information on the assets and liabilities held by trusts and companies, which would also be subject to a CGT. These holdings are likely to be significant. In some cases, we include assets owed by a trust as a rough proxy for assets held by family trusts.
- The value of assets and liabilities attributed by individuals in the sample are the individuals' estimates of market values, or the last rateable value (for real property). Such assessments will be subjective by nature and they may not be reliable indicators of true market values at the time of the survey.
- The SoFIE data can provide information on how assets and liabilities are distributed. Changes in the values of assets and liabilities can also be examined. However, SoFIE data cannot provide information on how capital gains are distributed, which is critical in determining precisely how a CGT could fall across the population. This is because the observed change in an asset's value contains a component due to changes in the price of the asset and changes in the quantity held, which cannot be separately identified. The capital gain is the component of the change in asset value due to changes in its price. If capital gains are not distributed in the same way as assets, conclusions drawn from the SoFIE data on that basis in relation to the distributional impact of a CGT will be in error. Our analysis is based on the assumption that capital gains will be distributed in the same proportions as capital assets.
- Non-residents are not included in the SoFIE population. It is highly likely that some non-residents will hold assets in New Zealand that would be the subject of a CGT. Therefore the SoFIE data will not show a complete picture of the potential assets subject to a CGT.
- The information on the first decile has an unusually low mean and median income – below that which would be the minimum if the individual or family received minimum levels of benefit assistance. This implies that the data may be influenced by low income earners in high income families, trust or other income, or self-employment in this first decile.

APPENDIX 2

Real property distributions across ethnic groups and age groups

The analysis in this appendix has been undertaken on individual, rather than family, data.

As Figure 2-A below shows, on average, the bulk of the value of real property is held by those categorising themselves as New Zealand/European, followed by those designating themselves as both non-New Zealand/European and non-Maori/Pacific Islander. Maori and Pacific Islanders directly hold the lowest value on average of the three groups.⁵⁶

Figure 2-A⁵⁷

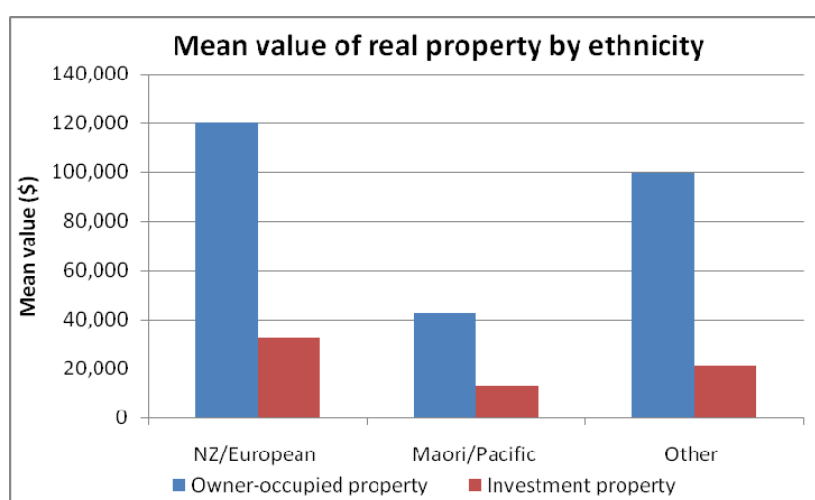
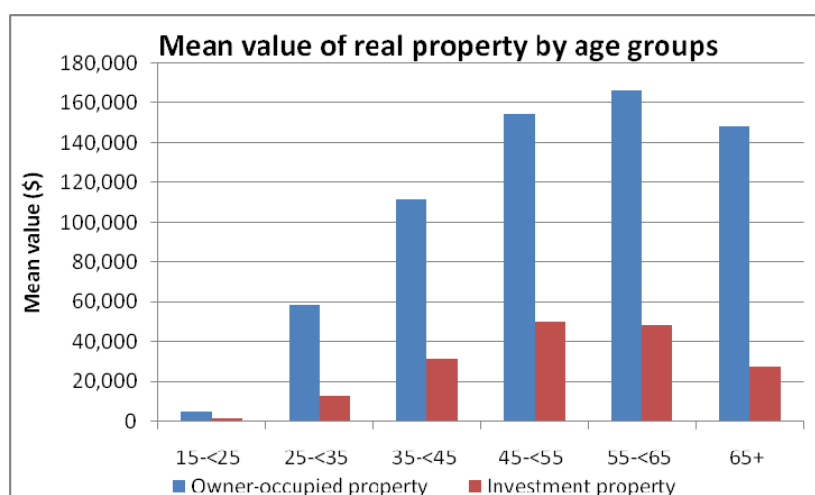


Figure 2-B below displays the distribution of the average mean value of real property by age:

Figure 2-B⁵⁸



⁵⁶ However, it should be noted that this data would not include any property held in Trusts for the benefit of Maori.

⁵⁷ This graph shows zeros e.g. it includes all those in the sample regardless of whether they own owner-occupied property or investment property.

⁵⁸ This graph includes zero values i.e. all those in the sample including those who do not own owner-occupied property or investment property. Investment property includes rental property.

Figure 2-B shows that the mean value of owner-occupied property increases significantly across age groups until the 65 + age group, where it drops. For investment property there is a relatively steep increase in mean value across age groups, peaking at 50,000 at the 45-55 age group. The mean value for investment properties in each age group is lower than that for owner-occupied property, with a range of values from \$4,000 to \$160,000 for owner-occupied property, and from \$1,000 to \$50,000 for investment property.

Figures 2-C and 2-D show the proportion of each age group that own owner-occupied property and investment property, relative to the average holding proportion of the population:

Figure 2-C

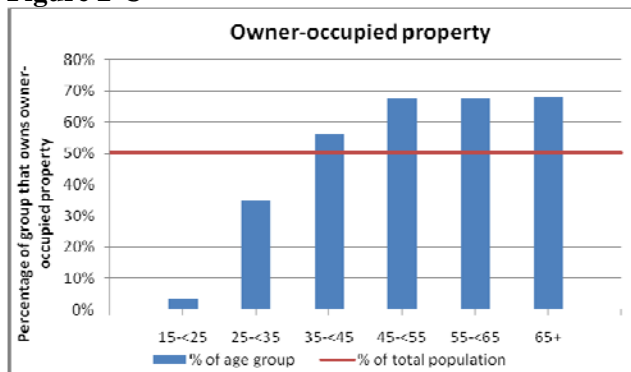
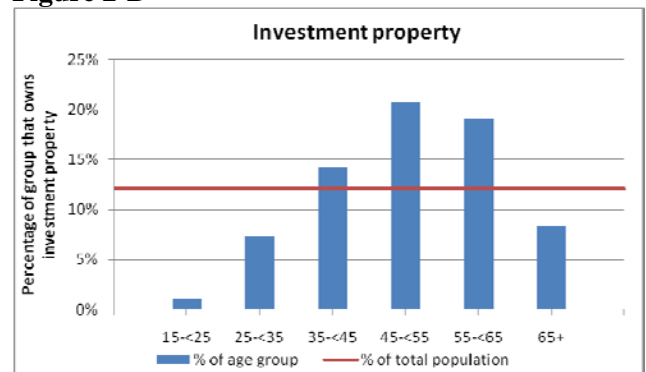


Figure 2-D



Figures 2-C and 2-D show that a large portion of the population holds owner-occupied property, with a significant portion of most age groups holding investment property. The data also indicates that most age groups (from 35 years upwards) hold significantly above the average population holding in relation to owner-occupied housing, whereas the age groups between 35-65 years hold above the population average in respect of investment property.

Conclusions from ethnicity and age data

If capital gains in New Zealand were distributed in the same way as the real property assets are as indicated above, taxing these gains would improve tax equity between ethnicities by ensuring those groups with the higher proportion of currently untaxed income were taxed on that income. Further, the taxation of capital gains could help reduce intergenerational inequity by ensuring that older age groups were liable for a fairer share of the tax burden by bringing within the tax net a form of untaxed income that they earn a proportionately greater share of.

APPENDIX 3

The Australian capital gains tax

Capital gains tax (CGT) was introduced in Australia on 20 September 1985.

CGT is the tax you pay on any capital gain you include on your annual income tax return. It is not a separate tax, merely a component of your income tax. You are taxed on your net capital gain at your marginal tax rate.

Australian marginal tax rates

Residents – Tax rates 2009-10

<i>Taxable income</i>	<i>MTR</i>
\$1 – \$6,000	Nil
\$6,001 – \$35,000	15%
\$35,001 – \$80,000	30%
\$80,001 – \$180,000	38%
\$180,001 and over	45%

Non-residents – Tax rates 2009-10

<i>Taxable income</i>	<i>MTR</i>
\$0 – \$35,000	29%
\$35,001 – \$80,000	30%
\$80,001 – \$180,000	38%
\$180,001 and over	45%

Generally, capital gains and capital losses from assets acquired before 20 September 1985 are exempt.

Roll over relief

Rollover allows a capital gain or capital loss to be deferred or disregarded until a later CGT event happens. The types of rollover available include:

Marriage breakdown

In certain cases where an asset or a share of an asset is transferred from one spouse to another after their marriage breaks down, any CGT is automatically deferred until a later CGT event happens (for example, until the former spouse sells the asset to someone else).

Loss, destruction or compulsory acquisition of an asset

You may defer a capital gain in some cases where a CGT asset has been lost or destroyed or is compulsorily acquired.

Scrip-for-scrip

You may be able to defer a capital gain if you dispose of your shares in a company or interest in a trust as a result of a takeover.

Demergers

You may be able to defer a capital gain or capital loss if a CGT event happens to your shares in a company or interest in a trust as a result of a demerger.

Other replacement asset rollovers

You may be able to defer a capital gain or capital loss when you replace an asset in the following circumstances:

- an individual or trustee disposes of assets to, or creates assets in, a wholly-owned company;
- partners dispose of assets to, or create assets in, a wholly owned company;
- a CGT event happens to small business assets and you acquire replacement assets;
- your statutory licence ends and is replaced with another statutory licence or licences which authorises substantially similar activity to the original licence or licences;
- you are a financial service provider who had assets – for example licences – replaced on transition to the financial services reform (FSR) regime;
- your property is converted to strata title;
- you exchange shares in the same company or units in the same unit trust;
- you exchange rights or options to acquire shares in a company or units in a unit trust;
- you exchange shares in one company for shares in an interposed company;
- you exchange units in a unit trust for shares in a company;
- a body is converted to an incorporated company;
- you acquire a Crown lease;
- you acquire a depreciating asset;
- you acquire prospecting and mining entitlements;
- you dispose of a security under a securities lending arrangement;
- a trust restructure ends your ownership of units or interests.

Other same asset rollovers

You may be able to defer a capital gain or capital loss when you transfer or dispose of assets in the following circumstances:

- an individual or trustee transfers a CGT asset to a wholly-owned company;
- a partner transfers their interest in a CGT asset to a wholly-owned company;
- a CGT asset is transferred between related companies;
- a trust disposes of a CGT asset to a company under a trust restructure;
- a CGT event happens because of a change to a trust deed of a complying approved deposit fund, a complying superannuation fund or a fund that accepts worker entitlement contributions; and
- a transfer of a CGT asset from one small superannuation fund to another complying superannuation fund because of a marriage breakdown.

Owner-occupied housing – residential home exemption

Generally, if you are an individual – not a company or trust – you can ignore a capital gain or capital loss from a capital gains tax (CGT) event that happens to a dwelling that is your “main residence” (see below).

To obtain full exemption from CGT:

- the dwelling must have been your home for the whole period you owned it;
- the dwelling must not have been used to produce assessable income (interest deductibility test applies); and
- any land on which the dwelling is situated must be two hectares or less.

This rule can change, however, depending on how you came to own the dwelling and what you have done with it – for example, if you have rented it out. If you are not fully exempt, you may be partially exempt.

If you inherited a dwelling or a share of a dwelling and it was not the deceased’s main residence, you may not get full exemption.

If a dwelling was not your main residence for the whole time you owned it, some special rules may entitle you to a full exemption or extend the part exemption you would otherwise get.

Main residence

The following factors may be relevant in working out whether a dwelling is your main residence:

- the length of time you live there – there is no minimum time a person has to live in a home before it is considered to be their main residence;
- whether your family lives there;
- whether you have moved your personal belongings into the home;
- the address to which your mail is delivered;
- your address on the electoral roll;
- the connection of services (for example, phone, gas or electricity); and
- your intention in occupying the dwelling.

A mere intention to construct or occupy a dwelling as your main residence – without actually doing so – is not sufficient to obtain the exemption.

Methods of calculation

There are three methods that are used to calculate a capital gain: the indexation method, the discount method and the “other” method. There is only one way to calculate a capital loss.

Indexation

You can use the indexation method to calculate your capital gain if:

- a capital gains tax (CGT) event happens to an asset you acquired before 11.45am (by legal time in the ACT) on 21 September 1999; and
- you owned the asset for 12 months or more.

Under the indexation method, you increase each amount included in an element of the cost base by an indexation factor.

The indexation factor is worked out using the consumer price index (CPI).

Discount method

The discount percentage is the percentage by which you reduce your capital gain. You can reduce the capital gain only after you have applied all the capital losses for the income year and any unapplied net capital losses from earlier years.

The discount percentage is 50% for individuals and trusts, and 33 1/3% for complying superannuation funds and eligible life insurance companies.

Example: Justin bought a block of land, held it for 18 months and sold it, making a profit of \$10,000. He has no capital losses. If he uses the discount method of calculation, he will declare a capital gain of \$5,000.

Other method

The “other” method is the simplest of the three methods for calculating a capital gain. You must use this method to calculate your capital gain if you have bought and sold your asset within 12 months or, generally, for capital gains tax (CGT) events that do not involve an asset. In these cases, the indexation and discount methods do not apply.

Generally, to use the “other” method, you simply subtract your cost base (what the asset cost you) from your capital proceeds (how much you sold it for). The amount of proceeds left is your capital gain.

Losses

For most CGT events, you make a capital loss if your total costs associated with the CGT event (the reduced cost base) exceed the capital proceeds you receive or are entitled to receive, from the event. That is, you sell an asset for less than what it cost you.

If your total capital losses for the year are more than your total capital gains, the difference is your net capital loss for the year. It can be carried forward to later income years to be deducted from future capital gains. You cannot deduct capital losses or a net capital loss from your income. There is no time limit on how long you can carry forward a net capital loss. You apply your net capital losses in the order that you make them.

Death

There is a general rule that CGT applies to any change of ownership of a CGT asset, unless the asset was acquired before 20 September 1985 (pre-CGT). However, there is a special rule that allows any capital gain or capital loss made on a post-CGT asset to be disregarded if, when a person dies, an asset they owned passes:

- to their legal personal representative or to a beneficiary; or
- from their legal personal representative to a beneficiary.

If the deceased died before 21 September 1999 and you dispose of a CGT asset (as beneficiary or legal personal representative) after that time and date, there are two ways of calculating your capital gain. You can use either the indexation method or the discount method, whichever gives you the better result.

- For the discount method to apply, you must be an individual, a trust or a complying superannuation entity and have acquired the asset at least 12 months before disposing of it. For the purposes of this 12-month ownership test, you are taken to have acquired the asset at one of the following times:
 - for pre-CGT assets, the date the deceased died; and
 - for post-CGT assets, the date the deceased acquired it.
- The indexation method is available if you acquire a CGT asset as a legal personal representative or a beneficiary of a deceased estate. The 12-month requirement is satisfied if the deceased acquired the asset 12 months or more before you disposed of it.

Source: Australian Tax Office website: <http://www.ato.gov.au> (last updated: 30 June 2009)