A TAX SYSTEM FOR NEW ZEALAND'S FUTURE

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Afternoon Session 1

Base broadening – taxation of capital income

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Base Broadening – Taxation of Capital

- Why consider base broadening?
- What's wrong with the current rules?
- What are the leading options?
- What are the pros and cons?
- What works?

Why Consider Base Broadening?

- Not simply a way of funding alignment of tax rates

- Base broadening needs to be considered in its own right to address concerns around growth, efficiency, integrity and fairness

Taxation of Capital – Problems with current rules

- Incoherent and arbitrary mix of taxation including:
  - Full accrual
  - Realisation
  - Imputed returns
  - Exempt
- Whether capital gains are taxable depends on:
  - What you invest in (ie asset class)
  - What form of entity you invest in (company, PIE, direct)
  - Where you invest (NZ, Australia, elsewhere)
  - How long you invest for (some property transactions)
- Hybrid model breaches every one of the core principles of a good tax system

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Taxation of Capital – Leading Options for Reform

- Capital gains tax
- Land tax
- Property tax
- Capital charge/wealth tax
- Risk free rate of return on rental properties
- Deny rental loss offsets
- Changes to limit depreciation deductions
- Tax profits on houses sold within set period

Capital Gains Tax – Overall Concept

- Include gains on capital assets in taxable income
- Tax at owner's marginal tax rate

Options:

- Full accrual basis
- Realisation

either including or excluding owner occupied houses and holiday homes

Revenue estimate: $8.89 billion including owner occupied homes
$4.54 billion excluding owner occupied homes

Capital Gains Tax – Pros

- Reduces biase in favour of investing in assets expected to create capital gains
- Enhances equity of tax system
- Scores well on progressivity criteria
- Could generate substantial revenue to fund tax rate reductions
- Brings NZ into line with other OECD countries
- The incremental or pragmatic approach to taxing capital gains has caused numerous distortions and significant uncertainty

Capital Gains Tax – Cons

- The ideal CGT, with accrual taxation of gains on ALL capital assets, is not feasible in practical or political terms
- As a result the typical CGT:
  - applies only on realisation
  - carves out owner occupied homes
  - quarantines capital losses
- Realisation based CGTs
  - create lock-in problems (ie incentive to hold on to appreciated assets)
  - may not generate material revenue if losses are allowed as a deduction

Capital Gains Tax – Cons *(ctd)*

- Excluding owner occupied homes means over 60% of real property is outside the CGT, and could create a new biase: the mansion effect
- Taxing gains on the sale of shares could cause double tax – contrary to intention of imputation
- A CGT would be complex to implement and administer
- Significant transitional and rollover issues
- Absent indexation, a CGT causes over-taxation, although deferral until realisation may compensate for this

… But some of these issues can be addressed in the design of the tax

Taxation of Residential Rental Housing – current position

- Amount invested $213 billion
- Tax losses recorded Approx. $500 million

⇒ Negative tax of $150 million to $200 million per annum

Q Is this justifiable on any rational policy grounds?

Taxation of Residential Rental Housing – possible options

Option A – Ad-hoc measures:

- Deny interest deductions
- Deny depreciation
- Deny ability to offset losses against other income
- Tax profits on sale of rental homes sold within 2 years

Option B – Comprehensive reform:

- Apply Risk Free Rate of Return (RFRM) to deem a notional return each year equal to (say) 6% of the value of the property
- Potential annual revenue of approx $700 million
- Gross annual revenue impact of $850 million

Risk Free Rate of Return (RFRM) in Practice

	$
QV of rental property	500,000
Mortgage	300,000
Net equity in property	200,000
Deemed return (6%)	12,000
Tax at 38%	4,560

Rental income not taxable

No deductions allowed for expenses or depreciation

Integrity concerns if limited to some asset classes

Impact on rents?

Other Base Broadening Options

	Est. Rev. $Billion
• Deny rental loss offsets	.165 to .195
• Deny depreciation on buildings	1.3
• Remove depreciation loading	.600
• Make depreciable buildings taxable on sale	1.3
• Tighten thin capitalisation threshold from 75% to 60%	.177
• Estate duty	?