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New Zealand's 'experience' with capital gains taxation and policy choice lessons from Australia

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Abstract

New Zealand taxes a number of types of capital gains as ordinary income at the standard income tax rates but it is an outlier within OECD countries for not having a separate comprehensive capital gains tax (CGT). Over the years, numerous proposals for a CGT have been made by political opposition parties as part of their policy platform; none of these parties have been successful in forming part of a government and, as such, their proposals have failed to come to fruition. The Tax Working Group in 2009 came very close to recommending a CGT for New Zealand as part of a portfolio of tax policy options. The bright-line test for the purchase and sale of residential property within two years of acquisition was introduced in 2015. The debate nevertheless continues over whether New Zealand should embrace a formal standalone CGT.

This article reviews previous attempts at introducing a CGT into New Zealand, traverses the ongoing debate, and outlines some of the key policy choices that need to be carefully examined should a future government announce that it is working on a CGT. The analysis is undertaken within a comprehensive tax base framework which applies income tax to net economic gain, adjusted for inflation. The article then considers modifications to this 'ideal' framework based on the design principles of equity, efficiency, simplicity, sustainability and policy consistency. Given Australia has had a CGT regime in place since 1985, with the regime going through several amendments in the intervening years, much of this analysis is drawn from that experience. In particular, Australia's politically controversial grandfathering clause, indexation versus discount model, and exemptions and concessions are discussed. The article concludes by providing recommendations as to 'ideal' policy choices should a CGT be again promoted as tax policy in New Zealand.

Key words: Australia, capital gains tax, New Zealand, possible reform

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1. INTRODUCTION

Incorporating provisions in a tax regime to impose tax on capital has long been regarded as difficult, both in theory and in practice.[1] Despite this difficulty, most developed nations have introduced regimes for taxing capital gains and New Zealand is a notable outlier within Organisation for Economic Co-operation and Development (OECD) countries for not having a separate capital gains tax (CGT). It does, however, tax a number of types of capital gains as ordinary income at the standard income tax rates. Over the years, numerous proposals for a CGT have been made by opposition parties as part of their policy platform; none of these parties have been successful in forming part of a government and, as such, their proposals have failed to come to fruition. The Tax Working Group (TWG) in 2009 came very close to recommending a CGT for New Zealand as part of a portfolio of tax policy options, but nevertheless failed to do so. The latest reform in this area, the bright-line test for the purchase and sale of residential property within two years of acquisition, was introduced in 2015. This was extended to five years in March 2018. However, debate continues over whether New Zealand should embrace a formal standalone CGT, with a CGT a notably contentious topic of New Zealand's political debate compared to that in other countries. This is in contrast to other areas of taxation reform where New Zealand has a very strong record of principled tax reform over many decades (the country's goods and services tax (GST) for example introduced in 1985 being considered a model of such a tax for countries to follow and benchmark for other such taxes to be measured against[2]).

This article reviews previous attempts at introducing a CGT into the New Zealand tax regime, traverses the ongoing debate, and outlines some of the key policy choices that need to be carefully examined should a future government announce that it is working on a CGT. The analysis is undertaken within a comprehensive tax base framework which applies income tax to net economic gain, adjusted for inflation. The article then considers modifications to this 'ideal' framework based on the design principles of equity, efficiency, simplicity, sustainability and policy consistency. Given Australia has had a CGT regime in place since 1985, with the regime going through several amendments in the intervening years, much of this analysis is drawn from that experience.

As to why Australia should be looked at for guidance, Australia is frequently considered as a first source of 'inspiration' for tax policy by New Zealand, and vice versa. This is in part due to the close relationship of the two jurisdictions and the relative similarity of their tax systems over a long period of their history. Income taxation itself was introduced in both societies in quite similar forms at around the same time (1891 in the then British colony of New Zealand, and the mid-1890s for several of the Australian colonies). Recent examples include Australia basing its goods and services tax (GST) model on the earlier New Zealand model, and New Zealand developing an approach for taxing goods purchased electronically based on the Australian approach. In the context of this article, since Australia already has a CGT, it should not come as a surprise that it would be the first choice for New Zealand to review.

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[1] Gordon Cooper and Chris Evans, *Australian CGT Handbook 2016-17* (Thomson Reuters, 8th ed, 2016) [1120], citing the International Monetary Fund, working paper (1991).
[2] See Rita de la Feria and Richard Krever, 'Ending VAT Exemptions: Towards a Post-Modern VAT' in Rita de la Feria (ed), *VAT Exemptions: Consequences and Design Alternatives* (Kluwer, 2013) 3, 10.

In particular, in the CGT context, Australia's politically controversial grandfathering clause, indexation versus discount model, and exemptions and concessions, are discussed. The rationale for the replacement of the indexation of the cost base nearly two decades ago with the 50 per cent discount is of particular relevance to this discussion as is the most recent debate around the perceived generous nature of this discount. Recommendations of the Australia's Future Tax System review (Henry Review), which included proposed changes to the CGT regime to ensure taxes supported productivity, participation and growth, are analysed. These recommendations revolved around streamlining small business CGT rules (Recommendation 17) and a common discount of 40 per cent for interest, net residential rents and capital gains (Recommendation 14).[3] The aim of the latter was to improve a shortfall in housing supply by providing a more neutral personal income tax treatment of private residential rent.[4]

Outside the scope of this article, however, is a discussion on the Australian CGT rules with respect to the treatment for non-residents who dispose of taxable Australian property (Div 855 of the *Income Tax Assessment Act 1997*) and capital gains withholding where the contract price is equal to or exceeds AUD 2 million (now AUD 750,000). Furthermore, it is beyond the scope of this article to specifically consider cross-border issues,[5] along with including discussion on the approaches to distinguishing between capital gains and ordinary income (other than briefly discussing the use of bright line tests). Another major CGT issue which is beyond the scope of this article is whether a CGT should apply to disposals of assets only or whether it should it extend to gains on the discharge of liabilities.

The remainder of the article is set out as follows. Section 2 discusses the key policy choices in relation to CGT. Section 3 then provides an historical analysis of New Zealand's approach to taxing capital gains along with failed attempts to introduce a comprehensive CGT regime. Section 4 follows with an analysis of Australia's CGT regime and provides an insight into some of the more controversial policy choices around the design of the CGT. The article concludes in section 5 by providing recommendations as to 'ideal' policy choices should a CGT be proposed as part of government tax policy for New Zealand.

2. CGT AND KEY POLICY CHOICES

Any proposal for the introduction of significant tax reform necessarily requires a consideration of the key policy choices that need to be carefully examined. The introduction of a CGT in New Zealand is no exception and, as such, this part of the article outlines those key policy considerations should a future government announce that it is working on a CGT. The analysis is undertaken within a comprehensive tax base

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[3] See Australia's Future Tax System Review Panel (Dr Ken Henry, chair), *Australia's Future Tax System: Report to the Treasurer* (December 2009) (Henry Review) Pt 1, xix.

[4] Ibid xxiii.

[5] In principle we are in favour of adopting the jurisdictional rules in the OECD Model Tax Convention on Income and on Capital (2017). However, indirect interests and the issues arising from the *Lamesa Holdings* case relating to the allocation of taxing rights under tax treaties to gains from transfers of shares in 'land-rich' entities (*Federal Commissioner of Taxation v Lamesa Holdings BV* [1997] FCA 785; 36 ATR 589) are important design issues requiring consideration in relation to a New Zealand CGT. See further on this case Kathrin Bain, Richard Krever and Anthony van der Westhuysen, 'The Influence of Alternative Model Tax Treaties on Australian Treaties' (2011) 26(1) *Australian Tax Forum* 31, 32-33.

framework which applies income tax to net economic gain, adjusted for inflation. The article then considers modifications to this 'ideal' framework based on the design principles of equity, efficiency, simplicity, sustainability and policy consistency.

2.1 Threshold considerations

As a starting point, countries often need to determine whether they wish to introduce a CGT at all and, as Evans points out, 'there is no real consensus as to what capital gains are or whether they should be taxed at all'.[6] A review of different regimes suggests a lack of unifying principle[7] and indicates that countries adopt numerous different approaches to the taxation of different forms of capital gains.[8] As such, while nearly all OECD countries have a CGT, with New Zealand as the notable outlier, the implementation and operation of those regimes differs. Evans also suggests that there is no one and ideal way to tax capital gains.[9] Each country considers its own reasons for introducing such a tax with 'fiscal equity' common, and other rationales such as 'widening the tax base, limiting income tax avoidance, improving vertical equity, and reducing investment distortion' also listed.[10]

The policy reasons for taxing capital gains are well-documented, with those same reasons providing the policy rationale for the design of a CGT regime. Justification for taxing capital gains generally lies in the concept of the comprehensive tax base, often considered the theoretical starting point to the design of an income tax regime.[11] The definition of the comprehensive tax base is generally accepted to be found in the Schanz-Haig-Simons framework which defines income as consumption plus changes in net wealth.[12] In 1938, Simons specifically defined personal income as 'the algebraic sum of (1) the market value of rights exercised in consumption and (2) the change in the value of the store of property rights between the beginning and the end of the period in question'.[13] With capital gains falling within the second part of the definition, failure to tax those gains is considered to breach the underpinning design principle of equity as there is a distortion of investment decisions with returns in the form of gains being treated preferentially.[14]

Ultimately, economic theory provides an underlying rationale for taxing capital gains and the design of a system for doing so. However, no country strictly adheres to the

[6] Chris Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?' (2002) 5(1) *Journal of Australian Taxation* 114, 114.
[7] Chris Evans and Cedric Sandford, 'Capital Gains Tax – The Unprincipled Tax' [1995] 5 *British Tax Review* 387, 403.
[8] For a comprehensive review of the approaches adopted by OECD countries, see OECD, *Taxation of Capital Gains of Individuals: Policy Considerations and Approaches*, Tax Policy Studies No 14 (OECD, 2006).
[9] Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6, 114.
[10] Cooper and Evans, above n 1.
[11] For a comprehensive review of the influence on different and often competing theories on the taxation of capital, however, see David White, 'Personal Capital Gains Taxation: Reflections on the Influence of Economic Theory on Tax Reform Proposals' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 18.
[12] Robert M Haig, 'The Concept of Income – Economic and Legal Aspects' in Robert M Haig et al, *The Federal Income Tax* (Columbia University Press, 1921) 1-28; Henry Simons, *Personal Income Taxation: The Definition of Income as a Problem of Fiscal Policy* (University of Chicago Press, 1938) 49.
[13] Simons, above n 12, 50.
[14] Chris Evans, John Minas and Youngdeok Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward' (2015) 30(4) *Australian Tax Forum* 735, 738.

comprehensive tax base.[15] In any current setting an 'ideal' model is modified to take into account the often competing imperatives of equity, efficiency, simplicity, sustainability and policy consistency. The five concepts, which we argue should be considered in the design of a CGT regime, formed the basis of recommendations contained in the report of the Australia's Future Tax System report of 2009 (known as the Henry Review after the chair of the Review Panel, then Treasury Secretary Dr Ken Henry) which was the most recent comprehensive review of Australia's tax regime. Arguably, this also takes us to the necessary consideration of optimal tax theory in which it is recognised that 'governments are trying to raise revenue in an economy that is inevitably distorted'.[16]

Ken Henry himself supported any move towards a comprehensive tax base despite recognising declining theoretical support for such an approach.[17] Ultimately, Australia's approach is one which combines the comprehensive tax base model with optimal tax theory. While equity, efficiency and simplicity are considered traditional tax policy principles, the latter two reflect a modern recognition of the need to take into account the way taxes and transfers affect people's behaviour and the economy.[18] As such, this article considers all five design factors.

2.2 Equity

Equity has long been considered the mainstay rationale for a CGT with both horizontal inequity and vertical inequity occurring without such a tax. Horizontal inequity occurs because individuals in similar circumstances may be treated differently where income is from capital gain compared to labour. Vertical inequity can also occur as it is generally higher wealth individuals who earn income from capital gains and benefit from a preferential regime. As such, when designing a CGT regime, policy-makers need to ask whether the proposed model treats individuals with similar economic capacity in the same way, while those with greater capacity bear a greater net burden. That is, is the overall system progressive?

2.3 Efficiency

Efficiency also needs to be considered, with policy-makers asking whether the proposed model raises and redistributes revenue at the least possible cost to economic efficiency and with minimal administration and compliance costs. Further, it is necessary to consider whether the system affects the choices people and businesses make by altering their incentives to work, save, invest or consume things of value to them. Efficiency is often considered to be breached without a CGT regime due to the distortions it potentially creates in investment decisions. As a general policy, it is argued that savings should be taxed as consistently as possible to minimise tax arbitrage opportunities. This avoids introducing bias into both 'household and investor decisions about what assets best suit their needs and preferences'.[19]

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[15] OECD, *Taxation of Capital Gains of Individuals*, above n 8.
[16] White, above n 11, 32. For a discussion of the extent to which the Henry Review may involve a shift from a comprehensive tax base to optimal taxation approach, see also Richard Vann, 'Never-Ending Tax Reform and Financial Services' (2011) 14(4) *Tax Specialist* 186, 187.
[17] Ken Henry, 'Towards a Better Taxation of Savings' (address to the Australian Conference of Economists Business Symposium, 1 October 2009), as cited by White, above n 11.
[18] Henry Review, above n 3.
[19] Ibid Pt 2, Vol 1, 64.

This second criterion of efficiency, however, is generally regarded as one which is hard to assess and is somewhat unclear in the argument for or against a CGT.[20]Efficiency will often only be addressed in a partial sense by introducing a CGT due to pragmatic considerations in the design of the tax as actually implemented in practice. As is discussed further in the context of Australia in section 4.2, in almost all instances, for example, there will be a deferral of liability to CGT on gains until realisation of those gains occurs rather than taxing the gains on an accruals basis. To take into account this deferral, most systems then also provide for an adjustment for inflation. There are several means for doing this including the original system in Australia of indexing elements of the cost base, or the current Australian system which provides for a discount for individuals and retirement savings funds and which was introduced as a notional alternative for indexation for assets acquired up to the date of the introduction of the discount. In some other instances, capital gains are taxed at a lower rate than other forms of income. There will also always be a bright-line boundary between ordinary income and capital gains which will provide an opportunity for 'gaming' by taxpayers with efficiency effects. In conclusion, however, policy-makers nonetheless must, within the context of a countries' priorities, consider the effects a CGT (or absence of a CGT) has on efficiency.

2.4 Simplicity

The third of the traditional criteria, simplicity, is seen as the most difficult to meet in regard to a CGT and it is generally a case of ensuring that any regime is not overly complex. While questions around simplicity are easy to ask, such as whether the system is easy to understand and simple to comply with and whether the system is transparent, a CGT regime is generally evaluated according to its complexity rather than as part of a general evaluation of simplicity, with policy considerations centred on reducing that complexity. As discussed in section 4.4 below, the greater the number of concessions and exemptions, the more complex a CGT regime will be. As noted in Australia's most recent comprehensive review of its tax system, 'principal drivers of the high administration and compliance costs include the complexity of the legislation, the frequency of changes to the legislation, the number of rules and exceptions, and record keeping requirements'.[21]

Notwithstanding these comments, the introduction of a CGT requires the will of the people and this in turn may mean that exemptions need to be part of the campaign to convince voters of such a tax. With these exemptions however, comes additional complexity and further costs imposed on taxpayers. As with all taxes, individuals are more likely to accept the introduction of an additional burden if they believe that it will be imposed on another taxpayer besides them. For example, if an individual believes that their property will be exempt from tax, they are more likely to support the introduction of a CGT.[22] A fundamental difficulty with the introduction of a CGT is the

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[20] Cooper and Evans, above n 1.
[21] Henry Review, above n 3, Pt 2, Vol 1, 78.
[22] This is largely due to that individual's likely assessment of receiving a relative tax advantage. See for example, the comment by Daniel Shaviro, in the context of tax simplification that '… [o]nce we get beyond slogans, however, [tax] simplification is a public good that few political actors value more than the opportunity to shift their own tax burdens to someone else'. Daniel Shaviro, 'Simplifying Assumptions: How Might the Politics of Consumption Tax Reform Affect (Impair) the End Product?' in John W Diamond and George R Zodrow (eds), *Fundamental Tax Reform: Issues, Choices, and Implications* (MIT Press,

fact that it is generally an extra tax which is not offset by a reduction or removal of another tax. Countries that have introduced a CGT have in general not provided a specific reduction in income tax as an offset for the increased taxes on gains, as occurred in the case of the GST in New Zealand in 1986. It can be noted, though, that Australia's September 1985 tax reform announcement which included the CGT also provided for a lowering of the top personal marginal income tax rate below 50 per cent from 1 July 1987, and this decade also saw substantial reductions in company tax rates[23] In overall terms, it has nevertheless been observed that '[t]ax reform is a *political* exercise'.[24]

2.5 Sustainability

Sustainability is the first of the non-traditional criteria and requires a tax system to have the capacity to meet the changing revenue needs of government on an ongoing basis without recourse to inefficient taxes. A tax system is considered to be sustainable where it contributes to a fair and equitable society. Ultimately, a country needs to determine the mix that it wants in terms of taxes, that is, what balance will be required between taxes on income, capital, personal, business, land and resources. Revenue considerations of a capital gains tax will be significant, given that introduction of the tax on the gains will often, at least politically, require allowance to be made in some form for capital losses.

In addition, as explained in the Henry Review, 'legal and administrative institutions and frameworks should also be robust to maintain the effectiveness of the system and underpin the legitimacy of the system. Policy settings should also contribute to environmental outcomes that are sustainable'.[25]

2.6 Policy consistency

Finally, a country needs to consider whether there is policy consistency throughout the whole of the tax regime. It cannot only consider the implications of a CGT regime in isolation, but also evaluate its internal consistency to see whether it contradicts any other part of the system and whether it is consistent with the broader policy objectives of the government.

2.7 Further considerations

Of course, factors which need to be taken into account and which influence the design of a CGT regime extend beyond these five core concepts. As White notes, 'key influences on future CGT reform other than current policy and practice include systems of political decision making, economic and technological change, ideology and, of course, ideas'.[26] In 2006, the OECD published a study it conducted asking countries to respond to a questionnaire about their CGT regime.[27] This study revealed five common

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2008) 75, 124, as cited in Binh Tran-Nam, Chris Evans, Richard Krever and Philip Lignier, 'Managing Tax Complexity: The State of Play After Henry' (2016) 35(4) *Economic Papers* 347, 355.

[23] See 'Keating aims for tax honesty, New package designed to get respect back into the system, Tax cuts ahead, immediate crackdown on lurks, mild gains impost' *Canberra Times* (20 September 1985) 1.

[24] Geoffrey Brennan and Michael Brooks, 'The Henry Tax Review: A View from Constitutional Political Economy' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (Thomson, 2010) 417, 417.

[25] Henry Review, above n 3, Pt 1, 17.

[26] White, above n 11, 20.

[27] OECD, *Taxation of Capital Gains of Individuals*, above n 8.

key considerations: securing tax revenues; efficiency considerations including 'lock-in effects; horizontal and vertical equity goals; encouraging savings and investment; and limiting taxpayer compliance and tax administration burdens.[28]

Further compounding CGT regime design decisions is the fact that concepts compete with each other, more often than not failing to offer complementary benefits. To this end, in the context of a CGT regime, 'arguments about the inequity of not taxing capital gains have outweighed the potential inefficiencies and complexities that inevitably accompany the introduction of such a tax'.[29] As such, we argue that the primary consideration needs to be one of equity. As discussed above, failure to tax capital gains leads to both horizontal and vertical inequity. What is often overlooked, however, is the fact that equity is improved simply because a CGT regime operates to protect the integrity of the tax base. As explained by Cooper and Evans: [30]

> the rationale for taxing capital gains is to be found primarily in the improved equity that such a tax introduces to the tax system. Without a CGT the potential for avoidance is immense. … A CGT protects the integrity of the income tax base by preventing leakage though dressing up or converting income to capital. In addition, the introduction of a CGT can leader to greater neutrality and efficiency in the tax system, though potentially at the cost of reduced simplicity.

Any proposal to introduce a CGT that is based on a 'revenue raising' objective may arguably be flawed. In relation to revenue raising, CGT regimes typically do not raise a lot of revenue but rather, they stem the leakage that would occur if there was no CGT regime. As such, a CGT regime operates as an integrity measure which protects the income base by preventing the re-characterisation of ordinary income into non-taxable capital gains. While revenue may be raised from the direct taxation of capital gains, it is the prevention of leakage and its effect on the integrity of the system as a whole that is perhaps the greatest benefit to the introduction of such a tax.[31]

Finally, as Krever and Brooks point out, there are characteristics of capital gains that make it technically difficult to tax these gains equitably, efficiently and simply.[32] In particular, they point to the fact that it is difficult to delineate the boundaries of the concept, that they are not normally realised on an accruals basis, neutrality is difficult to achieve, and there is an income/consumption tax tension.[33] In addition to these technical difficulties, there are the obvious political considerations which Krever and Brooks suggest further complicate the issue as to whether and how to design a CGT regime. They summarise these considerations as being, first, the furthering of social and economic objectives which mean that gains should be taxed preferentially and, second, ideological considerations centred on the argument between a progressive system and one that already taxes 'the rich' unfairly.[34]

[28] Ibid 31.
[29] Cooper and Evans, above n 1.
[30] Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6, 121.
[31] Ibid; Chris Evans, 'CGT – Mature Adult or Unruly Adolescent?' (2005) 20(2) *Australian Tax Forum* 291.
[32] Richard Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, 1990) 1.
[33] Ibid.
[34] Ibid.

For those who argue for the taxation of a comprehensive tax base, taxing all capital gains at marginal rates of tax results in the policy ideal.[35] Ultimately, however, the quest for an optimal tax structure which incorporates a CGT will inevitably involve trade-offs.[36] Optimal tax theory allows us to reconcile these trade-offs by combining traditional benchmark criteria to achieve a result which is the one that 'maximises social welfare, in which the choice between equity and efficiency best reflects society's attitudes toward these competing goals'.[37]

This section has discussed the theoretical basis for a CGT regime. Before considering Australia's comprehensive CGT regime in further detail in section 4 and making some recommendations for New Zealand moving forward in section 5, we now turn to a review of New Zealand's approach to taxing capital gains over the years prior to considering Australia's comprehensive CGT regime.

3. New Zealand – CGT in review

In this part of the article, we examine the history of the debate around New Zealand reforming its tax system to include a comprehensive CGT regime. New Zealand is currently recognised as an outlier within OECD countries for not having a separate CGT. However, as outlined here, it does tax a number of types of capital gains as ordinary income at the standard income tax rates. For example, if Inland Revenue believes a person is 'trading' in property or other investments for a living, the resulting capital gain is viewed as income from the property trading business and is taxed at the standard income tax rates.[38] Another common example is builders, developers and property dealers being required to pay tax on capital gains from properties held for less than 10 years.[39]

Furthermore, numerous proposals for a CGT have been made by opposition parties as part of their policy platform but none of these parties have been successful in forming part of a government, and as such, their proposals have failed to come to fruition. The closest that New Zealand came to the introduction of a CGT was via the Tax Working Group (TWG) in 2009-10 through its recommendation as part of a portfolio of tax policy options.[40] Perhaps most significant, and certainly most recent, is the introduction of the bright-line test, introduced in 2015, which applies tax to the profits from the purchase and sale of residential property within two years of acquisition. The debate nevertheless continues over whether New Zealand should embrace a formal standalone CGT. Each of these attempts, along with the current limited regime is discussed below.

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[35] Evans, Minas and Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward', above n 14, 744.

[36] Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

[37] Joseph Stiglitz, *Economics of the Public Sector* (Norton, 2nd ed, 1998) 478-479, as quoted by Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.

[38] See, for example, Inland Revenue, 'Property' in *Compliance Focus 2013-2014* (Wellington, 2013), available at: https://www.ird.govt.nz/aboutir/reports/compliance-focus/compliance-previous-years/compliance-focus-2013-14/other-focus-areas-13/property-13/.

[39] See *Income Tax Act 2007* (NZ) ss CB 9 to CB 12.

[40] See Tax Working Group, *A Tax System for New Zealand's Future: Report of the Victoria University of Wellington Tax Working Group* (Centre for Accounting, Governance and Taxation Research, Victoria University of Wellington, 2010), available at: https://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/pdf/tax-report-website.pdf.

3.1 The history of the CGT debate in New Zealand – early years through to 2009

In contrast to almost all other OECD countries, until recently, there has been very little discussion in New Zealand about the introduction of a CGT. Krever and Brooks, in their 1990 study on the New Zealand system, point out that when tax legislation was first passed in 1891, it was wide enough to incorporate a tax on capital but, like other Commonwealth courts, it was limited to the concept of income under trust law.[41] They also note that none of the early reports on taxation in New Zealand dealt extensively with the taxation of capital gains.[42]

While New Zealand did have an estate tax from the early years (ultimately repealed in 1999), later reviews increasingly began to focus on the capital gains tax issue itself. The taxation of capital gains was considered by the Ross Committee in their 1967 Report and in 1982 by the McCaw Committee in their 1982 Report,[43] while the sizeable report prepared by the Royal Commission on Social Policy in 1988 also extended to consideration of tax issues.[44] As in Australia at the time, targeted taxation measures were enacted in the 1970s and 1980s to address speculative excesses and perceived unfairness, such as New Zealand's property speculation tax of 1973 and the Muldoon government's measure in 1982 to recoup the amount of interest deductions previously enjoyed by a taxpayer by a tax on the sale of a property and held for less than ten years.[45] These measures inevitably met severe political resistance during their periods of operation which led to their repeal. Similarly, a significant debate in New Zealand at the time of Australia's introduction of the CGT in the mid-1980s led to the contrasting outcome in New Zealand of 'deferral' and eventual abandonment of the proposals at that time. More lasting reforms were also achieved, however, in relation to specific measures to tax (or codify and strengthen the existing rules for taxation of) various transactions involving land, such as land acquired for the purpose or with the intention of disposal, as part of a business relating to land or a land dealing or development business and so forth.[46]

By 2001, the CGT issue returned to prominence with the consideration of the measure by the McLeod Committee, which concluded in its Final Report:[47]

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[41] Krever and Brooks, above n 32, 36.

[42] Ibid.

[43] See Taxation Review Committee (L N Ross, chair), *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, 1967) (Ross Committee); Task Force on Tax Reform (Peter McCaw, chair), *Task Force on Tax Reform: Final Report* (Government Printer, 1982). See also Melinda Jacomb, 'A History of Taxing Capital Gains in New Zealand: Why Don't We?' (2014) 20 *Auckland University Law Review* 124, 132-135.

[44] The Royal Commission on Social Policy (Justice Ivor Richardson, chair), *The April Report: Report of the Royal Commission on Social Policy* (Government Printer, 1988).

[45] See further Robert Vosslamber, '"Removing a Parasitic Element": Speculation, Housing Affordability and the 1973 Property Speculation Tax' (2015) 21(2) *New Zealand Journal of Taxation Law and Policy* 169; Robert Vosslamber, 'What Looks Like a PST and Smells Like a PST...?" (2016) 22(2) *New Zealand Journal of Taxation Law and Policy* 106.

[46] See now ITA 2007 ss CB 6A to 15B. These measures include provisions to extend liability to associates which are seen by some as harsh.

[47] Tax Review 2001 (Robert McLeod, chair), *Final Report* (Government Printer, October 2001) (McLeod Review) 28, para 3.14, available at:
http://www.treasury.govt.nz/publications/reviews-consultation/taxreview2001/taxreview2001-report.pdf.

> … nothing … has altered our view … that New Zealand should not adopt a general realisation-based capital gains tax. We believe that such a tax would not necessarily make our tax system fairer and more efficient, would not lower tax avoidance and would not raise substantial revenue that could be used to lower tax rates. Instead, any such tax would be more likely to increase the complexity and costs of our system. The experience of other countries (such as Australia, the UK and the US) supports that conclusion.

The McLeod Committee proposed the taxation of a number of types of gains using a standard risk-free rate of return method (RFRRM), no matter the country of investment. This formed part of an issues paper released by the McLeod Committee on 20 June 2001, leading to a second round of consultations.[48] Public resistance to the application of the RFRRM on private housing led to this proposal not being included in the McLeod Committee's Final Report. However, the Minister of Revenue at the time (Dr Cullen) was interested in the RFRRM for an aspect of international taxation, on the basis that in his view it had the potential to make the relevant tax rules simpler, fairer and more effective. Dr Cullen indicated that the government would examine the Foreign Investment Fund (FIF) regime in this regard. A form of capital gains tax was introduced as the fair dividend rate. In this context, New Zealand has very specific forms of taxation of capital gains in its foreign investment fund (FIF) rules and the financial arrangement rules which had been introduced in 1986 and applied tax to gains from the holding of debt instruments among other provisions.

In summary, in 1990, Krever and Brooks pointed out that a consensus was developing in New Zealand among tax analysts that the failure to tax capital gains was a fundamental structural flaw in the New Zealand tax system.[49] As such, it is academics who have been significant contributors to the CGT debate in New Zealand. A review of their contributions since 2000 reveals a common theme of studying the experiences of overseas jurisdictions to learn from mistakes, as well as best practice. In this regard, a suggested acknowledgement that New Zealand is unique in its situation as a justification for not implementing a CGT has been put forward by policy-makers unwilling to make what is potentially seen as a tough decision to recommend a CGT for New Zealand. Even the major contributions of the Tax Working Group in 2009-10 and the outputs from more recent policy debates have failed to find a political champion for a CGT, unlike Roger Douglas and the GST in 1984.[50] The lack of any sort of 'political champion' has meant that the substantive contribution to the debate has been led by academics. Below, we summarise a number of the early contributions to the CGT debate in New Zealand.

Kenny concludes:[51]

> In line with the general international trend towards comprehensive income tax bases the case for a CGT in New Zealand is very strong. … Given the convergence of at least three of the tax policy criteria: efficiency, adequacy,

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[48] McLeod Review*, Issues Paper* (Government Printer, June 2001).
[49] Krever and Brooks, above n 32, 36.
[50] See, for example, the discussion on this topic in Adrian Sawyer, 'New Zealand's Successful Experience Introducing GST: Informative Guidance for Hong Kong?' (2013) 43(1) *Hong Kong Law Journal* 161.
[51] Paul Kenny, 'Capital Gains Taxation for New Zealand: Fairer and More Efficient' (2001) 7(4) *New Zealand Journal of Taxation Law and Policy* 265, 290 (emphasis added).

> and equity, *the case for the introduction of a comprehensive capital gains tax in New Zealand is compelling*.

Burman and White observe:[52]

> There is no perfect way to tax capital gains in a real-world income tax. Not taxing them, or *taxing them in an ad hoc and inconsistent fashion as is done in New Zealand invites unproductive tax avoidance, creates uncertainty for taxpayers, and is inequitable*.

Elliffe and Huang observe that New Zealand is unique, concluding:[53]

> The reason historically that New Zealand does not have a CGT is not because *New Zealand policymakers fail to recognise the benefits of such a form of taxation, but because they have been overawed by the perceived problems and cost associated with it*.
>
> In looking at the history of this tax policy, it is possible to conclude that the rejection is primarily due to unsubstantiated assertions that the law will become too complex from an administrative and technical perspective, and, bearing this burden in mind, is not worth the trouble from the revenue-collection perspective. …
>
> *One of the advantages of being the last to adopt something is that you can learn from others' mistakes*. Doing so, New Zealand could design a realised CGT which improves the tax system's equity, is administratively less complicated than other CGT systems, provides the tax administration with information, protects the integrity of existing rules, and still collects a realistic amount of revenue. … It seems logical to assume that *New Zealand can learn something from other countries' mistakes, and, even in some cases, successes.*

Coleman undertakes a modelling analysis of a potential CGT in the long term in New Zealand on housing market.[54] He finds that based on the assumptions of the modelling there will be different results. Specifically, the model which uses an overlapping generations framework to model the housing demands of participants, suggests a CGT will raise rents, increase homeownership rates, promote smaller houses, and increase the net foreign asset position. The welfare implications are less clear.

3.2 Tax Working Group – 2009-10

In 2009, following a conference held at Victoria University of Wellington, it was determined that an independent group, known as the Tax Working Group (TWG), should be established. The TWG, comprising experts from academia, Inland Revenue, the Treasury, and from tax practice, were tasked to undertake a review of the New Zealand tax system from a policy perspective. The TWG undertook widespread

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[52] Leonard Burman and David White, 'Taxing Capital Gains in New Zealand' (2003) 9(3) *New Zealand Journal of Taxation Law and Policy* 355, 385 (emphasis added).
[53] Chye-Ching Huang and Craig Elliffe, 'Is New Zealand Smarter than Other Countries or Simply Special? Reconsidering a Realisation-based Capital Gains Tax in the Light of South Africa's Experience' (2010) 16(3) *New Zealand Journal of Taxation Law and Policy* 269, 304-305 (emphasis added).
[54] Andrew Coleman, 'The Long-Term Effects of Capital Gains Taxes in New Zealand' (2010) 44(2) *New Zealand Economic Papers* 159.

consultation and extensive reporting to the New Zealand Government, which resulted in a series of recommended options for major tax policy reform. Specifically the TWG sought to:

1. Identify concerns with the current taxation system;
2. Describe what a good tax system should be like;
3. Consider options for reform; and
4. Evaluate the pros and cons of these options.[55]

During the third session of analysis, a realisation-based CGT for New Zealand was one of the major reform options open for discussion, along with a land tax and other forms of revenue raising from broadening the tax base. Burman and White provided arguments in favour of a CGT as a mechanism to improve efficiency, raise revenue, be progressive in its impact and assist with reduce taxes in other areas.[56] Inland Revenue and the Treasury were cautiously supportive in their submissions of a 'real-world' CGT that balanced theory with practical issues for New Zealand.

In its 2010 Report, the TWG concluded that New Zealand's tax system faced three critical issues:

1. Its structure was inappropriate;
2. It lacked coherence, integrity and fairness; and
3. Significant risks to the sustainability of the tax revenue base existed.

The TWG concluded in its 2010 report:[57]

> The most comprehensive option for base-broadening with respect to the taxation of capital is to introduce a comprehensive capital gains tax (CGT). While some view this as a viable option for base-broadening*, most members of the TWG have significant concerns over the practical challenges arising from a comprehensive CGT and the potential distortions and other efficiency implications that may arise from a partial CGT*.

This statement effectively 'hammered the nail into the coffin' for any further serious consideration of a CGT by officials and the New Zealand Government for the medium term. Creedy, in his review of the work of the TWG, offers considerable praise in commending the report to be read, concluding:[58]

> As mentioned earlier, the *strength of the report is in its attempt to contribute to rational policy debate by rehearsing the various arguments in a clear dispassionate manner, so that those on different sides of the debate can come*

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[55] Tax Working Group, *A Tax System for New Zealand's Future*, above n 40, 19.
[56] Leonard Burman and David White, 'Taxing Capital Gains in New Zealand: Assessment and Recommendations' (Paper presented to the Tax Working Group, 2009).
[57] Tax Working Group, *A Tax System for New Zealand's Future*, above n 40, 11 (emphasis added).
[58] John Creedy, 'Reflections on "A Tax System for New Zealand's Future"' (2010) 17(1) *Agenda: A Journal of Policy Analysis and Reform* 63, 72 (emphasis added).

> *to understand just why they differ*. That a disparate group of individuals from a range of backgrounds have established some common ground in a way of thinking about taxes is itself sufficient cause for praise. The Report can be read with interest and profit by all those interested in tax policy.

3.3 Bright-line test - 2015

Subsequent to the TWG report, there was little discussion on the introduction of a CGT for New Zealand. It was not until five years later that legislation was passed to introduce a very limited CGT for certain property – effectively what is considered another 'pseudo' CGT system. The bright-line test for determining the taxation of certain land sales came into effect on 1 October 2015.[59] Essentially, the gains from the disposal of residential land acquired and disposed of within two years will be taxable, subject to some exceptions.[60] The two-year bright-line period generally starts at the point a person has title for the property transferred to them and ends at the time the person enters into a contract to sell the property. There are specific rules for situations involving sales 'off the plan', where the two-year period runs from the date the person enters into a contract to buy the property to the time when a person enters into a contract to sell the property.

The bright-line test applies only to residential land where residential land is defined for these purposes to include: land that has a dwelling on it; land where the owner has an arrangement to build a dwelling on it; and bare land that can have a dwelling erected on it under the relevant district plan.[61] Exceptions to the bright-line test provide that residential land does not include business premises or farmland. Furthermore, the bright-line test does not apply to a person's main home. However, a person can only have one main home, so if they have more than one home, their main home is the one with which the person has the greatest connection. Special rules also apply to properties held in trust. The bright-line test also does not apply to property acquired through an inheritance and rollover relief is provided for property transferred as a result of a relationship property agreement. This means that any potential tax liability will be deferred until a subsequent sale.

Where property comes within the bright-line test, taxpayers will be allowed deductions for such property according to ordinary tax rules. These deductions can be offset against the income. However, losses arising from the bright-line test will be ring-fenced (quarantined) so that they may only be used to offset taxable gains from other land sales. There are specific anti-avoidance rules, in addition to the general anti-avoidance rule in s BG 1 of the *Income Tax Act 2007*, to counter companies and trusts being used to circumvent the bright-line test.

[59] For a useful overview, see Inland Revenue, 'Taxation (Bright-line Test for Residential Land) Act 2015' (2016) 28(1) *Tax Information Bulletin* 78.
[60] See *Income Tax Act 2007* s CB 6A. The period was extended to five years for agreements to purchase residential property entered into on or after 29 March 2018.
[61] See Inland Revenue, 'Bright-line test for residential land', special report, Policy and Strategy, Inland Revenue (November 2015), https://taxpolicy.ird.govt.nz/sites/default/files/2015-sr-bright-line-test.pdf.

In an early appraisal of the bright-line test, Reid and Tan review New Zealand's history with respect to CGT, and examine how the bright-line test fits within this. They conclude:[62]

> Finally, it is clear that the Government, past and present, is not in favour of introducing a comprehensive capital gains tax as it is believed that it would not produce the desired outcome. Until now, a pseudo capital gains tax system has always emerged as the preferred option in New Zealand, and the introduction of a bright-line test for the sale of residential property is the latest addition to this pseudo system. *One day, when the tax system reaches a point where there are too many pseudo capital gains taxing regimes in place, then perhaps the Government will concede that a comprehensive capital gains tax is indeed essential.*

More recently, Cassidy and Cheng assert that the bright-line test has specifically targeted Chinese nationals. They conclude:[63]

> *Section CB 6A of the ITA 2007 provides a new source of taxation for property gains made by Chinese nationals and the new RLWT ensures that tax is collected at settlement on the sale of properties by such persons*. However, the focus of this article has been the impact of these reforms on Chinese 'offshore persons' and 'offshore RWT persons' and the sharing of the information gathered through these measures amongst governmental agencies, specifically Chinese tax authorities. The new Land Transfer Tax Statement and [sic] that provides the conveyancer related changes in the requirements for obtaining an IRD number will significantly impact on Chinese nationals. Similarly, the RLWT measures include disclosure requirements by both the vendor and the paying agent. *The use of such information by IRD and, in turn, the sharing of such with Chinese tax authorities will ensure greater compliance in both jurisdictions.* As discussed earlier, it will also address the significant money laundering that is currently occurring in New Zealand.

The assertions by Cassidy and Cheng about the provisions being aimed at specific potential taxpayers cannot be conclusively established, however, and the bright-line test on its terms applies to all vendors of land whether resident or non-resident. The information requirements can also be considered both necessary and entirely conventional, fulfilling the role that stamp duty regimes fulfil in other jurisdictions (and which New Zealand does not have).[64]

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[62] Ian Reid and Lin Mei Tan, 'The Bright-Line Test on Residential Property Sales: Another Pseudo Capital Gains Tax Regime?' (2016) 22(2) *New Zealand Journal of Taxation Law and Policy* 157, 171 (emphasis added).

[63] Julie Cassidy, and Man Hung Alvin Cheng, 'The "Bright-line" Measures: The Tax Implications for China' (2017) 27(1) *Asia Pacific Law Review* 17, 27-28 (emphasis added).

[64] Furthermore, as a result of the money laundering concerns referred to by Cassidy and Cheng, New Zealand's foreign trust tax regime has recently undergone significant change recently following the Shewan review and the information requirements under the bright line regime mirror the requirements now imposed on New Zealand trustees of trusts settled by non-residents in New Zealand: see further, Government Inquiry into Foreign Trust Disclosure Rules (John Shewan, chair), *Report of the Government Inquiry into Foreign Trust Disclosure Rules* (New Zealand Government, June 2016).

Most recently, Tsen, Singh-Ladhar and Davey undertook a survey of practitioners and other tax professionals as to their views on the bright-line test. They conclude:[65]

> *Concern regarding the bright-line test is well founded and the authors note that the similar opinions from participants should be an indication that further policy consultation and development is required* – perhaps forming the basis for further research regarding the types of additional policy tools that could be used to integrate new tax rules into the statute books. However, *it is accepted that the bright-line test will likely aid the Inland Revenue Department in some way* – even if to reduce some level of compliance and administration costs so that their limited resources can be used elsewhere.

With the setting up of the new Government in late 2017, it has delivered on its promise with an extension of the bright-line test period from the current two years to five years, with effect from 29 March 2018.[66] The result of this extension is that the provisions now tax medium-term gains rather than short-term gains as they did originally. Concerns have also been raised around the limited exemptions which are viewed as being not nearly as generous as the Australian 50 per cent concession for individuals.

The initial two-year period for the bright-line test resulted in a question around whether the provisions imposed a form of capital gains tax or ordinary income tax. It is well established that real estate purchased for the purpose or intention of subsequent disposal is already taxable as income and the introduction of bright-line test merely provided an objective rule to the purpose/intention test contained in the provisions. However, the extension to five years suggests that the provision now operates in a way more akin to a true capital gains tax.

3.4 Current debate (post-Tax Working Group)

Post the TWG, Barrett and Veal look at the CGT debate through the manner in which it has been portrayed in the media, observing that the broadly accepted theoretical reasons for countering the judicial distinction drawn in income tax jurisprudence between capital and revenue were not adequately explained. In this regard, the challenge is for tax academics to play a greater role in engaging with the public through simplifying the arguments and working with the media.[67]

During the 2011 General Election campaign, the New Zealand Labour Party had a CGT as part of its manifesto. Maples reviews the CGT proposal, offering compliments on the

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[65] Lydia Tsen, Jagdeep Singh-Ladhar and Howard Davey, 'Is the Future Too Bright? An Empirical Investigation of Whether the Bight-line Test is Sound Tax Policy' (2017) 23(3) *New Zealand Journal of Taxation Law and Policy* 331, 349 (emphasis added).

[66] See further Inland Revenue, 'Tax bill passes third reading', media statement relating to the Taxation (Annual Rates for 2017-18, Employment and Investment Income, and Remedial Matters) Bill (subsequently assented to on 29 March 2018), http://taxpolicy.ird.govt.nz/news/2018-03-28-tax-bill-passes-third-reading.

[67] Jonathan Barrett and John Veal, 'Equity versus Political Suicide: Framing the Capital Gains Tax Debate in the New Zealand Print Media' (2013) 19(2) *New Zealand Journal of Taxation Law and Policy* 91.

quality of the work done. However, he cautions that the focus must be on maintaining clear policy:[68]

> *The success of a CGT, or any tax, will depend on a clear policy rationale which informs the design, consultation and implementation phases.* A failure to clearly articulate its purpose and adhere to it will potentially lead to a poorly designed and functioning CGT. Further, policymakers can expect to face heavy lobbying with any such future tax. *Keeping a clear focus of the object(s) of the tax will ensure that pressure from lobby groups do not derail the tax.*

The 2011 Labour Party CGT proposal contained some similar features to the existing Australian regime, such as the small business retirement concessions, but in contrast to Australia made only quite limited provision for relief for capital assets already owned. Transitional provisions, as Maples points out, are always a difficult issue to deal with and Australia is unique in terms of its 'grandfathering' of what are known as 'pre-CGT' assets. The proposal arguably also did not adequately address the potential contradiction involved in seeking to address housing affordability concerns in the situation where Australia and other jurisdictions nevertheless have similar or greater housing affordability problems even with their CGT regimes in place (though whether those problems would be worse without the CGT remains an open question).

The most recent major contribution to the debate is a special issue of articles in the *New Zealand Journal of Taxation Law and Policy* in 2015.[69] The articles largely come from a conference held in 2014 that were part of a wider examination of the key issues involved in the design of CGT regimes.[70] It was intended to inform the debate, not promote the introduction of a CGT. In their editorial, Elliffe and Littlewood comment that the key issues discussed include:[71]

- Whether the CGT should be integrated as part of the income tax provisions or a separate stand-alone tax;

[68] Andrew J Maples, 'A Comprehensive Capital Gains Tax in New Zealand – No Longer Political Hari-Kari?: A Consideration of the Labour Party Proposal of 2011' (2014) 20(2) *New Zealand Journal of Taxation Law and Policy* 144, 167 (emphasis added).

[69] The articles included in this Special Issue are: Peter Vial, 'New Zealand's Tax Base "Kumara"' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 14; David White, 'Personal Capital Gains Taxation: Reflections on the Influence of Economic theory on Tax Reform Proposals' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 18; Shelley Griffiths, '"The Game is Not Worth the Candle": Exploring the Lack of a Comprehensive Capital Gains Tax in New Zealand' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 51; Jacob Spoonley, 'A Sanctuary from the Taxman?: The Design of the Primary Residence Exemption' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 69; Craig Elliffe, 'Key Issues in the Design of Capital Gains Tax Regimes: Taxing Non-Residents', (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 90; Shaleshni Sharma and Howard Davey 'Characteristics of a Preferred Capital Gains Tax Regime in New Zealand' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 113, and Aaron Quintal, David Snell and Nicholas Chan, 'Key Issues in the Design of Capital Gains Tax Regimes: The Impact on Tax Practice' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 137.

[70] Additional papers have recently been published in a book: Michael Littlewood and Craig Elliffe (eds), *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Edward Elgar, 2017).

[71] Craig Elliffe and Michael Littlewood, 'Editorial' (2015) 21(1) *New Zealand Journal of Taxation Law and Policy* 11.

- How to introduce such a tax (only in respect of assets acquired after the implementation date or in respect of gains occurring after implementation on any asset held at the implementation date)?
- Whether the rate of tax on capital gains should be similar to the rate of tax on income or lower?
- Whether capital losses should be available to offset against ordinary income or only capital income?
- Whether we should tax non-residents on a less comprehensive basis than residents? and
- What exemptions should be available (personal residence and rollover relief for businesses and farms), how should they be structured (should they be unlimited or capped at a dollar value), and when should they be available (in respect of each transaction or upon death)?

Elliffe and Littlewood conclude:[72]

> New Zealand is a small and open economy. *While the experience of overseas jurisdictions in dealing with difficult and significant tax and economic matters can be extremely helpful to New Zealand policymakers* in their attempt to create the best settings for a vibrant and successful New Zealand society, *it is also necessary to focus on New Zealand specific issues* in order to create the best outcome.

Needless to say, Australia's CGT is not the only model for New Zealand to consider. Recently, James and Maples, in using the UK's CGT as the basis of a model for developing a CGT for New Zealand, conclude:[73]

> As a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the pragmatic approach of the UK. Two related lessons can be drawn from the UK experience. First, tax policy, principles and tax administration all have an important role in the design, reform and operation of CGT. Second, it is not easy to separate each aspect with regard to each individual feature of the UK CGT. Often all three dimensions are involved and sometimes in more than one way. The relationship between the three is therefore a close and complex one and trade-offs are required. With respect to the NZ proposals, *the UK experience is that all three dimensions (tax policy, tax principles and tax administration) should all be carefully considered*. In addition, as the UK experience demonstrates, *a successful tax policy also has to take account of political realities.*

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[72] Ibid 13 (emphasis added).

[73] Simon James and Andrew Maples, 'The Relationship Between Principles and Policy in Tax Administration: Lessons from the United Kingdom Capital Gains Tax Regime with Particular Reference to a Proposal for a Capital Gains Tax for New Zealand' (2016) 14(2) *eJournal of Tax Research* 455, 485 (emphasis added).

Most recently, Evans and Krever have laid the ground work should New Zealand decide to formally develop policy for implementing a CGT. They conclude:[74]

> New Zealand enjoys an enviable reputation for the range and quality of many aspects of its tax policy process, legislative provisions and administrative systems. Much of the innovation is based upon its status as a "first mover" in tax (and other) matters. *Ironically, it is a "last mover" so far as CGT is concerned, but that may not be such a bad thing. It certainly enables New Zealand to seek out world's best practice and also to learn from other countries' mistakes*. South Africa - when it introduced its CGT in 2001 - clearly benefited from a careful analysis of the CGT issues and problems that beset countries like the United Kingdom (1965), Canada (1972) and Australia (1985) when they introduced their regimes. As such, its regime probably combines the best features of those other countries, customised for local conditions.

The September 2017 General Election has now also come and gone. In the lead-up to the General Election, only one of the major political parties formally proposed a CGT for New Zealand. The Green Party has called for a CGT on all residential properties, except for the family home.[75] The Labour Party did not pursue its 2011 plan for a CGT at the 2017 General Election.

On 19 October 2017, it was announced that the next government would be a formal coalition between the Labour Party and NZ First Party, with a confidence and supply agreement between the Labour Party and the Green Party. In forming the new Government, the possibility of a CGT for New Zealand came a little closer. While the Labour Party initially left open the possibility of a capital gains tax,[76] the Government tasked the TWG with devising proposals for reform which would be taken to the next General Election in 2020 for the electorate to endorse (assuming that Labour was able to form another Government).

No formal statement has emerged as yet with respect to whether a CGT is on the government's agenda; this is in spite of the release of Government TWG's interim report in September 2018.[77] The Government TWG in its interim report sets out two potential options for extending capital income taxation in New Zealand. These are extending the tax net to include gains on assets that are not already taxed, and taxing deemed returns from certain assets (known as the risk-free rate of return method of taxation). Feedback

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[74] Chris Evans and Richard Krever, 'Taxing Capital Gains: A Comparative Analysis and Lessons for New Zealand' (2017) 23(4) *New Zealand Journal of Taxation Law and Policy* 486, 509 (footnotes omitted, emphasis added).

[75] See Green Party, *Economic Policy – Smart, Resilient and Fair* (2014) 13, available at: https://www.greens.org.nz/page/economic-policy.

[76] See Dan Satherly, 'Capital gains tax only for "select group of fortunate New Zealanders" – Davis', *Newshub.co.nz* (8 September 2017), https://www.newshub.co.nz/home/election/2017/09/capital-gains-tax-only-for-select-group-of-fortunate-new-zealanders-davis.html. The Labour Party's support for a capital gains tax at the 2014 General Election was apparently dropped as an explicit policy in favour of a TWG review of the matter following a change of Labour leadership in 2015: see Pattrick Smellie, 'Tax an NZ election issue' *Acuity* (19 September 2017), available at: https://www.acuitymag.com/business/capital-gains-tax-shapes-up-as-nz-election-issue (accessed 31 January 2019).

[77] Tax Working Group*, Future of Tax: Interim Report* (New Zealand Government, September 2018), available at: https://taxworkinggroup.govt.nz/resources/future-tax-interim-report.

on these options from the public is intended to inform the recommendations in the Government TWG's final report in February 2019.

It would appear that the government still intends to seek a mandate for a CGT from the 2020 General Election. Individuals appointed to the Government TWG, such as Professor Craig Elliffe, are well known advocates of the capital gains tax. When the TWG was first set up, restrictions were placed on its advisory ability with such matter as taxes on family homes being off the table. No doubt, from a political perspective, capital gains exemptions for owner- occupied property is necessary, however the directive went beyond merely a capital gains tax to prevent any discussion on a broad based land tax such as that proposed in 2010.

The previous coalition government, prior to the 2017 General Election, continued to maintain its opposition to a CGT. Thus, overall the notion of a CGT remains highly politically sensitive. As discussed earlier, the new Government has delivered on one of its promises with an extension of the bright-line test period from the current two years to five years, with effect from 29 March 2018.[78] It should also be noted that the above discussion has focused on specific legislative reform proposals put forward by governments, and has not considered the underlying process of judicial interpretation of the capital-revenue boundary (and the apparent lack of political response to shifts in that boundary[79]).

4. AUSTRALIA – CGT IN REVIEW

The discussion in section 2 above considered the key policy considerations any country may take into account to determine whether to introduce a CGT regime and what that regime might look like. It then noted that the failure of any sort of comprehensive CGT in New Zealand tends to stem from a failure of a clear policy rationale or a misunderstanding of what that rationale should be. It is also noted however that while theoretical considerations can be applied broadly, each country will have different imperatives. The historical and current debate in New Zealand, discussed in section 3 above, suggests that the taxing of capital gains is an ongoing political issue and a CGT is likely to be introduced at some time in the future, with numerous issues already having been raised.

As such, having considered appropriate policy rationale and principles, this article now turns to the various pragmatic considerations New Zealand will arguably face in the future in determining the form of CGT provisions it adopts, by a comparison with the experience in Australia with introduction of its model in the mid-1980s. While general theoretical and tax policy considerations need to be taken into account, pragmatic difficulties, as evidenced by existing regimes, also assist New Zealand in this process. Given the parallels New Zealand has with Australia, including not only similar economic conditions but similar tax regimes, much of this analysis will be drawn from that experience.

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[78] See further Inland Revenue, 'Tax bill passes third reading', above n 66.
[79] See, for example, *Commissioner of Inland Revenue v Rangatira Limited* (1995) 17 NZTC 12,182 (CA). The Privy Council eventually decided the case (in the taxpayer's favour) on procedural grounds but left the Court of Appeal's findings on the tests for assessability of gains by an investment business otherwise intact; see *Rangatira Limited v Commissioner of Inland Revenue* [1996] NZPC 7; [1996] UKPC 54.

Australia has had a CGT regime in place since 1985, with the regime going through several amendments in the intervening years. In particular, concepts such as the grandfathering of pre-CGT assets, along with Australia's politically controversial exemptions and concessions, are considered. Further, the rationale for the replacement of the indexation of the cost base nearly two decades ago with the 50 per cent discount is of particular relevance to this discussion, as is the most recent debate around the perceived generous nature of this discount. Prior to a discussion on the current contentious issues in Australia's CGT regime, a short history is provided.

4.1 History of Australia's CGT regime

Australia's history concerning a CGT differs significantly from that of New Zealand. It introduced a comprehensive CGT regime in 1985. Prior to this date, there was limited taxation of capital gains in the form of two provisions: section 26(a) of the *Income Tax Assessment Act 1936* (later section 25A of that Act and ultimately section 15-15 of the *Income Tax Assessment Act 1997*) and section 26AAA (ultimately repealed in 1994) of the *Income Tax Assessment Act 1936*. The former, relying on a determination of the taxpayer's intent, included in the assessable income of a taxpayer profits arising from the sale of property acquired for the purposes of profit-making by sale or the carrying on or carrying out of any profit-making undertaking or scheme. The latter taxed short-term capital gains by including in assessable income of a taxpayer the profit on the sale of property held for less than 12 months. Neither provision proved successful as they could be easily manipulated.

In 1974, the Asprey Committee[80] recommended the introduction of a CGT in Australia but ultimately this was dropped by the Federal Government in 1975. It was not until ten years later, in 1985, that a CGT was once again recommended.[81] A Draft White Paper was released by the government of the day on 4 June 1985 and the CGT regime was officially announced on 19 September 1985 as part of the *Reform of the Australian Tax System*[82] and became effective as at that date. As such, Australia has had a comprehensive CGT regime from 20 September 1985. Like most regimes which tax capital gains, it taxes gains on a realisation basis with capital losses quarantined against any gains and able to be carried forward indefinitely. Assets acquired before that date are grandfathered and known as pre-CGT assets.[83] The original regime allowed an indexation adjustment to the cost base to take into account inflation where the assets was held for more than 12 months and there was a capital gain. However, indexation and averaging was abolished from 20 September 1999, and replaced with a 50 per cent discount for individuals where assets are held for more than 12 months.

Early changes to Australia's CGT regime came about after it became clear in the early 1990s that the original provisions in Part IIIA of the *Income Tax Assessment Act 1936* were not working well.[84] In particular, they were viewed as being unnecessarily

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[80] Taxation Review Committee (Australia) (Justice Kenneth Asprey, chair), *Full Report* (Australian Government Publishing Service, 31 January 1975).
[81] Australian Treasury, *Reform of the Australian Tax System: Draft White Paper* (Canberra, 1985).
[82] Ibid.
[83] In contrast to the original enacting legislation for the Australian CGT regime, there is now no single rule supporting this statement; rather, it is refracted through the different CGT events, for example *Income Tax Assessment Act 1997* (Cth) s 104-10(5)(a) (CGT Event A1). See, by contrast, *Income Tax Assessment Amendment (Capital Gains) Act 1986* (Cth) s 19, enacting s 160L of the *Income Tax Assessment Act 1936*.
[84] Cooper and Evans, above n 1.

complex in both their presentation and expression.[85] At that time, the legislation was rewritten to remove deeming provisions which attempted to fit certain transactions into the requirement for the disposal of an asset and replaced the triggering event with what is known as 'CGT events'. The rationale behind this change was to make the provisions more accessible and more flexible and to provide a logical and coherent structure.[86] The current provisions are contained in Parts 3-1 and 3-3 of the *Income Tax Assessment Act 1997*.[87] Ultimately, the rewrite, designed to be merely technical in nature rather than a changing policy, has also been viewed as a failure as have the two subsequent reviews, the Ralph Review[88] and the Henry Review,[89] both of which provided the opportunity for government to undertake substantive reform to the CGT regime. Neither opportunity however was embraced.[90] As such, as Evans and Cooper explain, 'consequently we are left with a CGT regime that is more complex than most of its overseas counterparts. Just why it became so complex can, in part, best be explained by reference to the reasons that underlie its initial introduction and subsequent development'.[91] Many of these reasons are outlined below in the context of discussion of the issues that Australia has faced and then of the policy determinations that New Zealand will have to make. In particular, we look at three areas which have proved controversial in Australia: the 'grandfathering' of certain CGT assets, indexation versus discount, and exemptions and concessions.[92]

4.2 Timing issues and a 'grandfather' clause

The introduction of a CGT immediately raises questions about retrospectivity. That is, should the tax apply to all transactions or only those transactions which involve the disposal of an asset which was acquired after the introduction of the legislation? Australia is no exception to this debate but now stands out as adopting a unique position of 'grandfathering' certain CGT assets.[93] In fact, one of the most controversial debates around the introduction of a CGT in Australia was the taxing of all gains accruing after the introduction of the legislation and Evans labels this as one of the most significant problem areas.[94] The initial proposal in the Draft White Paper was for the Australian regime to tax all gains with a valuation method used for assets acquired prior to the introduction of the tax.[95] Prior models, such as the United Kingdom regime introduced in 1965, offered taxpayers a choice between fair market value or apportionment as methods for determining the taxation of capital gains realised after the introduction of

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[85] Ibid, citing the Second Reading Speech to the Tax Law Improvement Bill (No 1) 1998 on 13 May 1998.
[86] Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.
[87] For a comprehensive analysis of the legislative provisions see: Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31.
[88] Review of Business Taxation (Australia) (John Ralph, chair), *A Tax System Redesigned: More Certain, Equitable and Durable, Final Report of the Review of Business Taxation* (Australian Government, July 1999) (Ralph Review), available at: https://rbt.treasury.gov.au/.
[89] Henry Review, above n 3.
[90] For a commentary on Australia's earlier tax reviews see: Chris Evans and Richard Krever, 'Tax Reviews in Australia: Before and After Henry' [2009] 4 *British Tax Review* 339.
[91] Cooper and Evans, above n 1.
[92] Most recently, there have been changes to the taxation of Australian assets held by non-residents. However, this is a topic worthy of consideration as an investigation in its own right and, as such, is outside the scope of this article.
[93] Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 305.
[94] Ibid.
[95] Ibid.

the legislation on assets acquired before that date[96] and was suggested as a possibility within the Australian model. However, ultimately, and after opposition in the Senate (upper House of Parliament), 'the compromise of "grandfathering", a uniquely Australian outcome that has bedevilled the Australian CGT since inception'[97] was reached. This is a position that Krever notes is 'condemned by tax economists throughout the nation and is often raised in international forums as an example of an absurd anomaly that should not be followed again'.[98]

In 2004, Evans proposed the phasing out of the grandfathered status of pre-1985 assets arguing that it is unique, anomalous, complex, inefficient and inequitable.[99] In 2010, the Henry Review recommended that 'grandfathering' be removed and New Zealand may wish to take note of this recommendation. It stated:[100]

> *Recommendation 17:*
>
> The capital gains tax regime should be simplified by:
>
> (c) removing current grandfathering provisions relating to assets acquired before the commencement of capital gains tax, with a market value cost base provided for those assets when the exemption is removed, or before the end of previous indexation arrangements. A relatively long lead-time should be provided before these removals take effect; …

Associated with timing and recognition issues is the question around taxing gains on an accrual or realisation basis. Under an 'ideal' model based on the comprehensive tax base, capital gains would be taxed on an accrual basis. Taxing capital gains on a realisation basis provides a deferral advantage as it lowers the effective tax rate on accrued capital.[101] This potentially impedes the 'efficient functioning of the capital market and distorts ownership patterns as investors are discouraged from switching assets when they would pay tax on a realised gain'.[102] However, this is generally considered unrealistic as there are practical impediments to such an approach. First, there is the need to accurately measure changes in asset values where there has been no actual realisation. Second, adopting such an approach would also add to compliance costs and differential tax treatments of assets. Third, taxing according to an accruals basis also has liquidity issues for taxpayers whose value is tied up in the asset rather than accessible for the purposes of paying any tax due. Fourth, taxing inflationary gains erodes consumption power and, in this context the alternative is seen as a better option as 'the impact of inflation is less of an issue for capital gain assets where taxation is deferred until realisation. In this case, the real post-tax return increases the longer an asset is held'.[103] Because of these pragmatic concerns, the realisation basis of taxing capital gains is generally adopted. However, this also is not without its issues.

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[96] Canada also adopts a similar approach.
[97] Cooper and Evans, above n 1.
[98] Richard Krever, 'The Taxation of Capital Gains' in Stan Ross and Philip Burgess (eds), *Income Tax: A Critical Analysis* (Law Book Company, 2nd ed, 1996) 67, 107-108.
[99] Chris Evans, 'Taxing Personal Capital Gains in Australia: Complexity and Proposals for Reform' (2004) 19(3) *Australian Tax Forum* 371, 408.
[100] Henry Review, above n 3, Pt 1, 84.
[101] Henry Review, above n 3, Pt 2, Vol 1, 63.
[102] Ibid.
[103] Ibid Pt 2, Vol 1, 65.

The most significant problem associated with the realisation model is what is known as the 'lock-in' effect. Essentially, taxpayers defer disposing of assets to defer the payment of any tax on the realised gains. This is exacerbated in Australia because of the grandfathering of certain CGT assets.[104] In addition, taxation based on the realisation principle also provides tax arbitrage opportunities as a taxpayer has an incentive to hold assets which have made a gain and realise assets which have made a loss. The consequence of this arbitrage opportunity is that a CGT regime generally needs a provision restricting the use of losses. It is also argued that under the realisation principle, additional complexity and compliance costs are introduced. The Henry Review states: [105]

> Under a realisation-based tax, taxpayers are required to keep records for long periods, and are also likely to have less frequent exposure to the relevant tax rules. Separating capital gains from other forms of income also creates uncertainty, and arbitrage opportunities, over how particular forms of income should be classified for tax purposes.

There is considerable discussion in the literature concerning lock-in, and the accruals versus realisation basis.[106] It is generally accepted that lock-in is produced by not taxing capital gains on an accruals basis. However, this does not necessarily mean that lock-in is produced by taxing capital gains on a realisation basis in itself. Rather, not taxing capital gains at all may produce more lock-in than taxing them on a realisation basis. Furthermore, Taylor discusses a number of provisions that arise due to the grandfathering of pre-CGT assets and other exemptions, such as the private residence, suggesting a number of possible reforms.[107]

4.3 Indexation versus discount

When Australia first introduced a CGT, the model contained a provision allowing the cost of an asset to be indexed to take into account inflation in determining the net capital gain to be taxed. This approach, which ensured only real gains rather than notional or inflationary gains were taxed, remained in the regime from 1985 to 1999 when it was replaced with a discount method. The rationale for indexation, which was tied to inflation, was to ensure that only 'real' gains were taxed. The change to the discount method, introduced in 1999 as part of the Ralph Review recommendations, was designed to 'enliven and invigorate the Australian equities markets, to stimulate greater participation by individuals, and to achieve a better allocation of the nation's capital resources'.[108] It was recognised by the Ralph Review that 'an exclusion of 50 per cent of capital gains for eligible assets held for a year or more by individuals will increase

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[104] Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 307.

[105] Henry Review, above n 3, Pt 2, Vol 1, 64.

[106] See, for example, Matthew Benge, 'Capital Gains and Reform of the Tax Base' in John G Head and Richard Krever (eds), *Taxation Towards 2000* (Australian Tax Research Foundation, 1997) 351 and Charles C Holt and John P Shelton, 'The Lock-in Effect of the Capital Gains Tax' (1962) 15(4) *National Tax Journal* 337; Alan J Auerbach, 'Retrospective Capital Gains Taxation' (1991) 81(1) *American Economic Review* 167.

[107] C John Taylor, 'CGT Reform and the Reduction of Tax Law Complexity' (2008) 23(4) *Australian Tax Forum* 427. The provisions noted in this article are also noted in some of the simplification literature; see for example, Chris Evans and Binh Tran-Nam, 'Controlling Tax Complexity: Rhetoric or Reality?' in Chris Evans, Richard Krever and Peter Mellor (eds), *Australia's Future Tax System: The Prospects After Henry* (Thomson Reuters, 2010) 439.

[108] Ralph Review, above n 88, 598.

significantly the attractiveness of investing in capital-gains-bearing assets by individuals'.[109] As Evans explains, the focus of the CGT reforms recommended by the Ralph Review centred on optimising economic growth, with very little focus on equity and only some recognition of the importance of simplicity and certainty.[110] The discount method currently adopted by Australia is in line with the Canadian model, while other jurisdictions such as Portugal, Chile and Spain maintain a methodology that takes into account inflation. However, most OECD countries treat the full capital gain as taxable, with some providing for an exemption up to a fixed amount.[111]

The abolition of indexation and replacement with the 50 per cent discount method largely reintroduced inequity into the system by preferentially taxing gains. As Evans notes, the essential reason for introducing a CGT is one of equity, yet a 50 per cent discount 'savagely offends both the horizontal and the vertical aspects of equity'.[112] It has already been noted that salary earners are disadvantaged over investors and that wealthier individuals tend to be the ones who invest for capital gain. This inequity can also be demonstrated by comparing the taxing of capital gains with the taxing of other forms of savings income and, in this context, it is necessary to consider how the taxation of capital gains fits within the broader tax system and the taxation of savings income. For example, in Australia, interest is taxed the least favourably because the entire return, including any inflationary gain, is taxed at marginal rates. On the other hand, dividends and investment in shares is taxed favourably, with dividends attracting a dividend imputation credit and capital gains from the sale attracting the CGT discount. Property is also taxed favourably depending on whether there are gains or losses, with the CGT discount again applying to any gain, and owner-occupied housing is exempt altogether from tax. That said, capital gains on shares are arguably preferred relative to interest because of the CGT discount. Furthermore, with a fully effective imputation system (this includes where excess imputation credits are refundable) dividends are taxed at the shareholder's average tax rate and this treatment applies to the taxation of interest as well.

Different tax consequences between capital gains, interest, dividends and real property, as illustrated above, result in obvious horizontal inequity in the tax regime. As noted by the Henry Review, these differences affect the assets in which households invest, leading to 'adverse impacts on overall economic efficiency, capital market stability and the distribution of risk between individuals'.[113] Because of the tax incentives, investors tend to take on too much debt, and in the case of real estate, it leads to a distortion in the property market.[114] Further compounding this favourable treatment of capital gains under the personal income tax system is the fact that investments can be geared so as to bring about interest deductions against the gains from the investment. To this end, the Henry Review recommended major reform in this area. It stated:[115]

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[109] Ibid 599.
[110] Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.
[111] OECD, *Taxation of Dividend, Interest, and Capital Gain Income*, OECD Tax Working Papers No 19 (OECD, 2013) 35.
[112] Evans, 'Taxing Capital Gains: One Step Forwards or Two Steps Back?', above n 6.
[113] Henry Review, above n 3, Pt 1, 33.
[114] Ibid.
[115] Henry Review, above n 3, Pt 1, 83.

> *Recommendation 14:*
>
> Provide a 40 per cent savings income discount to individuals for non-business related:
>
> (a) net interest income;
>
> (b) net residential rental income (including related interest expenses);
>
> (c) capital gains (and losses); and
>
> (d) interest expenses related to listed shares held by individuals as non-business investments.

It will be noted that, not only did the Henry Review recommend that the discount be reduced to 40 per cent, but also that it be extended to 'like' types of income. The rationale for this recommendation was that by discounting net rental income at the same rate as capital gains, the tax treatment of investor housing would be less responsive to gearing levels and capital gains, creating a more neutral treatment of different forms of savings. They argued that the 'proposed reforms would reduce the bias in favour of the capital gain generated in rental properties by treating it more neutrally compared to rental yield'.[116] However, in 2010, the then Federal Government ruled out any reduction in the discount rate.

In terms of the inequity of the current system, the Henry Review stated that:

> a move to a broad 40 per cent discount for income from bank deposits, bonds, rental properties, and capital gains and for certain interest expenses would address these problems by providing more consistent tax outcomes. Savings would be allocated more productively, distortions to rental property and other markets would be reduced, and household investment and financing choices would better suit their circumstances and risk-preferences. The discount would also provide a means of adjusting for the effect of inflation, which increases the effective rate of tax on savings income.[117]

A reduction in the discount rate, along with its extension to other forms of income, does not necessarily reduce the inequity between the taxing of capital and labour income. To this extent, the Henry Review also recognised the need to consider how the boundaries are set between discounted and non-discounted amounts:

> to achieve certainty, reduce compliance costs, and prevent labour and other income being converted into discounted income. Further consideration should also be given to addressing existing tax law boundaries related to the treatment of individuals owning shares in order to address uncertainties about when the shares are held on capital account (and subject to CGT) and on revenue account (and taxed as ordinary income).[118]

Australia's adoption of an indexation method to calculate any net capital gain, followed by its replacement with a 50 per cent discount, offers two examples of how CGT models

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[116] Ibid Pt 2, Vol 2, 417-418.
[117] Ibid Pt 1, 33-34.
[118] Ibid Pt 1, 83.

can be implemented. However, we suggest that the 50 per cent discount is suboptimal due to the inequity which is inherent in such a regime.

4.4 Exemptions and concessions

Perhaps one of the most controversial aspects of the CGT regime in Australia involves the exemptions and concessions, of which there are many. Australia's current CGT regime applies to all CGT assets unless either the asset is exempt or the capital gain or loss is exempt. Of significance are the following:

1. Exemption for main residence;
2. A gain made from personal use assets, acquired for less than $10,000 and all losses from personal use assets;
3. Collectables acquired for up to $500;
4. Motor vehicles;
5. Trading stock; and
6. Depreciable assets.

The housing market is perhaps one of the most affected markets when it comes to tax policy. In section 4.3 above, we discussed the influence the CGT discount can have on housing policy. In addition, it has been noted that '[t]he housing market is also affected by the exemption of owner-occupied housing from the personal income tax and the capital gains tax system…'.[119] There is an incentive to invest in a main residence for capital growth which is then tax free on realisation. However, taxing capital gains on main residences is one of the most politically contentious issues around CGT. No doubt, this would also be controversial in New Zealand if a CGT was introduced. In Australia, the consequence of the main residence exemption has been individuals over investing in their homes on the basis that any capital gain is free from tax. Further, there is no limit on the amount which can be spent or the gain that can be exempt on a main residence provided the property meets the necessary requirements, and the land size for the exemption is extremely generous and beyond the size of most urban properties. To date, Australia has not had a backlash against the taxation of vacation properties. However, this may occur in New Zealand as the ownership of vacation properties seems to be more common in New Zealand than Australia.[120]

Small business CGT concessions are also controversial and can be particularly advantageous to those who can access them. Taxpayers who can access these

[119] Ibid Pt 2, Vol 2, 415.

[120] On the transition in the Australian vacation property sector to one involving both dwelling and investment ownership, see Chris Paris, 'The Changing Ecology of Australian Second Homes' (2017) 14(3.4) *e-Review of Tourism Research* 92; and on the broader evolution of the New Zealand second home sector over many decades and the government policies of the different eras, see Trudie Walters, 'Caves to Castles: The Development of Second Home Practices in New Zealand' (2019) 11(1) *Journal of Policy Research in Tourism, Leisure and Events* 1.

concessions certainly welcome these concessions.[121] A small business is able to access the concessions where it has an annual turnover of less than AUD 2 million or net assets do not exceed AUD 6 million. Where a small business meets one of the threshold tests, it may access one or a combination of the 15-year asset exemption, 50 per cent active asset reduction, retirement exemption or a roll-over. The 15-year asset exemption will exempt the total capital gain from tax where the taxpayer is 55 years or older and retiring, and has owned an active asset business for at least 15 years. The 50 per cent active asset reduction means that where a taxpayer owned an active business asset (asset used in the business) tax will only be paid on 50 per cent of the gain. The retirement exemption allows a taxpayer who is under 55 to contribute up to AUD 500,000 tax free to a complying superannuation fund and a taxpayer who is over 55 to have an exemption for the AUD 500,000. Finally, a roll-over allows the taxpayer to defer any tax on the capital gain to purchase a replacement asset. These small business concessions may also be applied in conjunction with the 50 per cent discount.

The rationale for favourable treatment is that for many business owners, their personal effort and capital investment is rewarded through appreciation of the value of the business and its assets, often in the form of goodwill and intangible assets. For self-employed taxpayers, the concessions mean that tax on business gains can be deferred until ultimately realised and that gain on realisation is significantly reduced, if not completely exempted. There are obvious efficiency and equity concerns around these concessions and the effect that they have on the labour market favouring self-employment.[122]

The question remains as to why a country would adopt small business concessions. Apart from the political perspective that these concessions make a CGT more palatable, there can be alternative rationales for them. This includes roll-over of such incentives from one business to another, as well as providing incentives for start-ups. With respect to start-ups, the Australian concessions largely apply at what is the wrong end for most small businesses. That is, these concessions are provided largely when the business ends rather than when it commences.[123]

These small business concessions are a known area of significant complexity within the CGT regime. Evans has previously found that these concessions ranked prominently in the drivers of CGT compliance costs.[124] He concluded that not only have these provisions become more complex over time but that the provisions are so complex that professional advice is normally required before a taxpayer can avail themselves of the benefits of the provisions.

Further, simplicity may be introduced into a CGT regime via an indexed annual exempt amount as proposed by Evans in 2004.[125] Data shows that a large percentage of individuals contribute a very small proportion of the tax on capital gains. As such, an annual exempt amount would significantly reduce compliance costs for many taxpayers. This proposal was further investigated by Evans, Minas and Lim in their 2015 study.

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[121] Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 313.
[122] Henry Review, above n 3, Pt 2, Vol 1, 51.
[123] See for example, Naomi Kewley, 'The Old, the New, and the Ugly: A Comparative Analysis of the UK, South African and Australian CGT Small Business Concessions - With Recommendations for Australia' (2013) 28(2) *Australian Tax Forum* 257.
[124] Evans, 'Taxing Personal Capital Gains in Australia: Complexity and Proposals for Reform', above n 99.
[125] Ibid 411-412.

As the authors point out, preferential CGT rates are 'usually linked to providing an incentive for entrepreneurship and risk taking, increasing the level of saving, investment and productivity and counteracting the "lock-in effect"'.[126]

Again, as noted in section 4.2 above in relation to the grandfathering rule, the most recent review of Australia's tax system which New Zealand may wish to take note of is the suggested simplification of the current regime around exemptions and concessions:

> *Recommendation 17:*
>
> The capital gains tax regime should be simplified by:
>
> (a) increasing the exemption threshold for collectables and exempting all personal use assets;
>
> (b) rationalising and streamlining the current small business capital gains tax concessions by:
>
> – removing the active asset 50 per cent reduction and 15–year exemption concessions;
>
> – increasing the lifetime limit of the retirement exemption by permanently aligning it with the capital gains tax cap for contributions to a superannuation fund; and
>
> – allowing taxpayers who sell a share in a company or an interest in a trust to access the concessions via the turnover test.

5. RECOMMENDATIONS FOR NEW ZEALAND

In conclusion, in this section we outline both considerations and recommendations which will be relevant, should New Zealand seriously consider a CGT in the near future. While policy considerations in section 2 of this article may provide an 'ideal' regime, it can be seen from the pragmatic considerations in section 4, that there are many variations to such a model. Indeed, earlier in section 3, which reviewed the CGT debate in New Zealand, it could be argued that the country is ideally positioned to embrace a formal CGT proposal.

The recommendations made in Australia's most recent comprehensive tax review, combined with previous studies, suggest that Australia's exemptions and concessions provide too much complexity within Australia's CGT regime and this is compounded when combined with grandfathering of pre-1985 assets. Broadly, the Henry Review found that 'the current capital gains tax rules are particularly complex, with that complexity compounded by various exemptions and the grandfathering of previous provisions',[127] and provided recommendations around simplifying the regime to address these issues. Perhaps then the most significant lesson from Australia for New Zealand is centred on the complexity found in the current model. While the system itself may be considered complex by necessity, this is compounded by both the grandfathering of pre-CGT assets along with the various exemptions and concessions. The most complex

[126] Evans, Minas and Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward', above n 14, 745-746.
[127] Henry Review, above n 3, Pt 2, Vol 1, 80.

areas are discussed above, and perhaps one of the most complex is the various concessions for small business.

This complexity has been recognised in prior studies. Evans, in a 2004 study involving surveys of over 300 practitioners, found that:[128]

1. CGT compliance costs are significant;
2. they derive primarily from the complexity of the legislative provisions;
3. legislative changes in the late 1990s did little to improve the position; and
4. the CGT provisions are a major concern for practitioners.

Several of the above features of Australia's CGT regime, such as grandfathering, and the exemptions and concessions, contribute to this complexity. As noted earlier, simplicity may be introduced into a CGT regime via an indexed annual exempt amount.[129]

In order to advance a CGT for New Zealand, there needs to be a champion for the tax, which by necessity needs to be a senior member of the government. There would also need to be an educational programme to accompany the CGT policy proposal, as well as when the legislation is enacted (but prior to it coming into effect). In developing the New Zealand CGT model, we would argue that the lessons of the Australian experience are pertinent to developing a New Zealand -specific CGT. Thus, grandfathering of pre-CGT assets would not be sensible, and the number of exemptions and concessions should be minimal. The CGT should apply on a realisation basis, rather than accrual basis. It would need to exempt the family home in order to be politically palatable.[130] Building upon New Zealand's experience with introducing its goods and services tax over the period of 1984-1986, this would suggest that New Zealand should develop a largely 'pure' CGT and deal with major equity concerns outside of the CGT through other mechanisms, such as via income support.

Any possible CGT would ideally embrace simplicity and efficiency to ensure it would best fit within the current Broad Base Low Rate (BBLR) framework that operates in New Zealand. The BBLR is a coherent tax policy framework that seeks to appropriately balance (with trade-offs) a number of factors: efficiency; fairness; compliance costs; and administration costs. It aims to have a broad base of taxation while keeping tax rates as low as possible. Currently, the most significant 'gap' in New Zealand's BBLR is the absence of a CGT.[131] In order to buttress its BBLR, New Zealand should be actively pursuing the introduction of an appropriately structured CGT. For this to occur, it may

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[128] Evans, 'Taxing Personal Capital Gains in Australia: Complexity and Proposals for Reform', above n 99, 401.
[129] Evans, Minas and Lim, 'Taxing Personal Capital Gains in Australia: An Alternative Way Forward', above n 14, 745-746.
[130] See the comments by Michael Littlewood, 'Capital Gains Taxes – A Comparative Survey' in Michael Littlewood and Craig Elliffe (eds), *Capital Gains Taxation: A Comparative Analysis of Key Issues* (Edward Elgar, 2017) 1, 28.
[131] For further discussion on the BBLR, see Adrian Sawyer, 'Do Lawyers Make a Distinctive Contribution to Tax Policymaking?: Reflections on the Contributions of Lawyers to Tax Policymaking in New Zealand' (2017) 27(4A) *New Zealand Universities Law Review* 995.

require a change in government or serious financial crisis that puts the New Zealand tax base at significant risk.

With New Zealand operating its 'Generic Tax Policy Process' (GTPP), there is the opportunity for considerable input from stakeholders into both the policy composition and the draft legislation. The GTPP clarifies the responsibilities and accountabilities of the two major departments actively involved in the process (namely Inland Revenue and The Treasury). It also encourages earlier and more explicit consideration of key tax policy elements and trade-offs through the linking of its first three stages. Finally, the GTPP provides an opportunity for external input (such as from legal practitioners and firms) into the process for formulating tax policy. Such an approach seeks to facilitate both the actual and perceived transparency of the process, and provide for greater contestability and quality of policy advice.[132] New Zealand's experience with the GTPP has largely been successful with previous major tax changes since the process commenced in 1994. There is no reason to believe this should not be the same with introducing a well-constructed CGT.

The OECD, in a 2000 Economic Survey of New Zealand, recommended the introduction of a separate CGT.[133]

Seventeen years later, we are yet to see a change to this view or the adoption by the New Zealand government of the OECD recommendation. However, as Evans comments: '[t]he Australian CGT has endured bucket loads of amendments and refinements since 1985, and it is certain that there will be many more in the future. By its very nature the CGT will never be a simple tax'.[134] In this context, New Zealand can benefit from the Australian experience that is more than 30 years in the making.

[132] See further Adrian Sawyer, 'Reviewing Tax Policy Development in New Zealand: Lessons From a Delicate Balancing of "Law and Politics"' (2013) 28(2) *Australian Tax Forum* 401.
[133] OECD, *OECD Economic Surveys: New Zealand* (OECD, 2000).
[134] Evans, 'CGT – Mature Adult or Unruly Adolescent?', above n 31, 321.