U3A Wellington

Designing a fair tax system for New Zealand-what works, what doesn't?

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28 September 2018

Session overview

- A quick trip down memory lane
  -tax settings in the late 1970's early 1980's
  -the Lange/Douglas reforms of the 1980's
- The ensuing 20 years-relative stability
- The 2009 Tax Working Group & resulting changes
- The 2018 Tax Working Group's Interim Report-20 September 2018
  -Capital Gains Tax
  -other recommendations
  -work in progress
- What tax changes will the Government take to the 2020 election?

But first-what are we trying to do with taxes?

- **Year to 30 June 2019-Government plans to collect-**

  -$83.2 billion in direct tax, GST, and other indirect tax

  -$ 5.6 billion in ACC, fire service & EQC levies, fines & other

- **Revenue taxes-** the objective being to raise money as fairly and efficiently as possible to fund the workings of Government

  PAYE & other taxes on salaries & wages, company tax & GST

  (currently about 88% of total tax comes from these three sources)

- **Corrective or behavioural taxes-** the objective being to change behaviour away from activities with harmful side effects and to encourage activities with beneficial side effects

  Excise taxes on tobacco & alcohol, gambling levies, transport taxes

  (about $7 billion for 2019, of which 25% is excise on tobacco)

The late 1970s/early 1980s saw a sharp increase in the use of behavioural & corrective taxes

- New Zealand facing severe economic challenges post Britain's decision to join the European Union
- Tax policy response-introduction of a range of generous tax incentives to encourage exports, investment in manufacturing and farming and alternative sources of fuel
- By 1981 there were about 70 specific business tax incentives with a fiscal cost of about 42% of the total tax take
- Personal tax rates had to be increased significantly to pay for them-top personal tax rate of 66% on income over $38,000
- Evasion and avoidance sky-rocketed
- Trust in the fairness and integrity of the tax system fell sharply
- New Zealand was in a perilous financial position-rising deficits, debt

Key take-away from the period 1978 to 1984

There is a point at which the public will simply rebel if tax rates or policies reach a point where people feel they are manifestly unfair

By 1984 the position was akin to widespread civil disobedience

Normally law abiding citizens refused to work 2/3 of the day for the state

1984 to 1989-the Lange/Douglas Government overhauled the tax system

- Personal and company tax rates reduced significantly
- 10% GST introduced from 1 October 1986
- Virtually all tax incentives repealed
- Imputation introduced to eliminate double taxation of company profits
- Taxation of retirement savings changed to remove tax preferences
- Fringe Benefit Tax introduced
- Extensive consultation preceded the reforms- a new feature
- Not everything went well- eg deregulation of foreign exchange markets without a robust international tax regime caused major problems with flight of funds to tax havens

1990-2010

- Broad base/low rate approach to tax policy followed by the Bolger, Shipley & Clark Governments, with some variations in emphasis eg the Clark Government increased the top personal rate from 33% to 39%, and introduced a research & development tax credit
- Major tax review undertaken in 2001 (the McLeod Committee)- interim report suggests a radical change to taxation of housing to impose a tax on the imputed rent from living in your own home- conceptually sound but public reaction was overwhelmingly negative
- McLeod Committee concludes that the broad architecture of the tax system is sound-

  'The broad base low rates approach developed over the last twenty years is sound and should be continued.'

2009/2010 Victoria University Tax Working Group

- Independent from Government, but set up with their support and with access to Treasury and IRD resources for analysis of options
- Supported broad base low rate approach to tax policy BUT
- Concluded that New Zealand was relying too much on taxes most harmful to growth (ie tax on personal earnings and business profits)
- Noted major hole in tax base concerning the taxation of capital, resulting in tax burden being borne disproportionately by PAYE taxpayers
- Major recommendations-

  -reduction in personal tax rates and alignment of entity tax rates

  -increase in GST from 12.5% to 15%, with compensation for low paid

  -low level land tax as an alternative to a Capital Gains Tax

The 2018 Tax Working Group's Interim Report

- Hot off the press-released Thursday 20 September 2018
- To date, limited media & analyst comment in response
- Surprising given-

  (a) the report signals major policy change in several areas

  (b) the design of the CGT likely to be recommended is spelt out

  (c) a number of key decisions are final and are specified as such

  (d) several areas of expected change have been ruled out

  (e) the report and Government's response reflect some significant philosophical differences relative to earlier expert reports

  (f) the content will be central to the 2020 election campaign

TWG Interim Report
Starting with the surprises-first tier issues

- Drop in company tax rate (now 28%) rejected
- Progressive tax rate for smaller companies also rejected
- Land tax ruled out
- Strong message discouraging further increases to excise tax on tobacco (tax borne largely by low income earners)
- Tax concessions for retirement savings for sub $48k income earners
- Theme that tax & by inference tax rates should be more progressive
- Two options for taxation of capital gains under consideration

  -traditional (as used in other places) realisation based CGT

  - Risk Free Rate of Return tax on net equity invested in capital assets
- The potential revenue ($6 billion after 10 years) projected from a CGT and the *'no discounted rate for capital gains'* recommendation

TWG Interim Report
Continuing with the surprises-second tier issues

- Suggested tax on empty houses and vacant land
- Recommendation that Government be ready to impose an ‘equalisation tax’ on aspects of digital economy
- Review (with a view to restricting) current ability of charities and other non-profit bodies to recover 100% of the GST they pay
- Consider if accumulation of business income by charities is appropriate or if tax exemption should require distribution- review suggested following the current review of Charities Act
- Consider if a distinction should be applied between privately-controlled foundations and other charitable organisations
- No reference to tax treatment of sports clubs
- Kicked for touch on possibility of sugar tax

TWG Interim Report
Important final decisions that are not a surprise

- Do not remove GST from products such as food and drink
- Retain imputation system
- Retain 17.% tax rate for Maori authorities & extend to subsidiaries
- Retain exemption for business income derived by charities
- 'Significant scope' seen for tax instruments to play a greater role in delivering positive environmental and ecological outcomes eg expanded Waste Disposal levy, strengthen Emissions Trading Scheme, consider taxes to address water pollution and abstraction
- No wealth tax
- No land tax
- No inheritance tax
- No financial transactions tax

TWG Interim Report and Government's Response: Underlying themes that are set to shape tax policy making over the next few years

- Concern over reliance on narrow range of taxes (personal income, company income and GST) for 90% of tax collected
- Potential threats to these tax bases due to macro trends: the rise of the contractor, robotics, Artificial Intelligence, globalisation and the digital economy
- Clear view that overall tax base needs to be broadened
- Tax is seen as one tool to be used to reduce inequality
- Strong focus on a balanced savings culture & deeper capital markets
- Government asks that TWG further consider the role of the tax system in delivering environmental and ecological outcomes
- Pervasive theme of fairness & integrity in the design of tax policy

Turning to capital gains-the ‘case for’ is no longer based on solving housing affordability

TWG’s Interim Report-

‘ ..the Group’s view is that tax has not played a large role in the current state of New Zealand’s housing market, and will be unlikely to play a large role in fixing it’.

Comment- It defies basic economics to argue the imposing a tax on housing but exempting 60% to 65% of houses from it (because they are owner occupied) will have a material impact on house prices

The ‘case for’ will now be put primarily in the context of ***fairness***

Two options under consideration for taxing capital gains

Option A

Extend the existing tax net through a ***Realised Capital Gains Tax*** that will apply to all land & buildings (excluding the family home), shares, savings such as shares within KiwiSaver accounts, business assets (including farms, shares in private companies, goodwill)

Option B

A ***Risk Free Rate of Return*** method that imposes tax on deemed income each year. Deemed income = the equity held by the owner of the asset (ie market value less debt) X risk free rate (say 2% currently)

Almost certainly the TWG's final recommendation will be Option A

Designing New Zealand's CGT-the really big issues?

- **Scope** What's in, what's out?
- **Timing** Is CGT payable annually, or on realisation?
- **Rate** Payable on 100% of gain at normal rates, or discounted?
- **Rollover** Can CGT be deferred in some situations? When & why?
- **Losses** Are capital losses tax deductible?

TWG's current thinking

- Everything is in except family homes and personal assets
- Gains taxable on realisation at normal tax rate with no discount
- Rollover allowed in many situations
- Losses deductible but *probably* only against capital gains

Transition to Capital Gains Tax

- TWG recommends that only capital gains arising from the date CGT applies from be subject to the new CGT rules
- Requires a valuation of all affected assets on 'CGT day'
- CGT day seems likely to be the 1st day of the income year that commences following the 2020 election

Thursday 1 April 2021

By coincidence this is April Fools' day!

Capital Gains Tax
The hot topic of family homes

- What qualifies as a family home? To be known as *Excluded Property*
- Life-style blocks-scope of land exclusion (4,500 square metres?)
- Farm houses
- Homes owned by trusts and companies
- Homes that are inherited on death of family member
- Homes used for homestays and/or rented out through *Air B & B*
- Homes left empty for a period and then resume use as family home
- Holiday homes
- Mansions
- Dealing with changes in use

Capital Gains Tax
The hot topic of rollover relief-when should it apply?

Objective: Defer tax on sales that involve special circumstances

Problem: If *too liberal* the CGT is undermined and ineffective

If *too tight* the CGT may distort investment & be unfair

Examples

- Gifts on death or during a person's lifetime
- Involuntary sales eg compulsory land purchase by the local council
- Sale of farm or other business assets as part of upgrade to bigger or more efficient farm/business
- Distributions of assets from family trusts
- Family or other business reorganisations

Will New Zealand see a CGT in 2021?
The fascinating world of politics

- Highly likely that the TWG will recommend CGT and Government will agree to take it to the next stage-ie

  - legislation introduced to Parliament around July 2019

  - passed by end of 2019 with effective date 1 April 2021
- CGT will be centre stage during the 2020 election campaign
- Labour and the Greens will support, National and ACT will oppose
- What will Winston do?
- What will the public do?

Addendum-Taxation of housing: untaxed capital gains are only half the tax problem

Non-taxation of imputed income confers a significant tax advantage on home owners

Example

-Lily & Harry have each saved $500k

-Lily buys a house with her savings. Harry invests his savings and pays $600 a week ($31,200 a year) in rent

-Harry receives $30k in investment income which incurs $9k in tax

Tax consequences

- Lily has no investment income so has no tax to pay

- Harry pays $9k in tax

-Harry and Lily are in exactly the same economic position pre tax

Is this a fair result?