Capital Gains Tax: The Final Word

The much-anticipated final report of the Tax Working Group (TWG) was released on 21 February and, unsurprisingly, recommended the introduction of a broad-based, realised capital gains tax regime. The Final Report is substantial at two volumes and 206 pages, 94 of which are dedicated to a discussion on a capital gains tax (CGT) regime.

Whilst there are some changes from the Interim Report released last September, the recommendations are substantially the same as those contained in that report. Interestingly, only eight out of eleven of the TWG members support the introduction of a comprehensive CGT regime.

As always, the devil is in the detail and it will take some time for the entire 206 pages to be digested. However, a summary of the recommendations is as follows:

What will be taxed?

- The following assets (included assets) would be subject to CGT: all forms of land except the family home, shares, intangible property, and business assets. The TWG recommends excluding personal use assets such as cars, boats, jewellery, fine art, collectibles, and other household durables.
- Only gains arising after "valuation day" would be taxed.
- Taxpayers would have up to five years to determine the market value of assets as at valuation day. If a valuation is not obtained, a "default rule" would apply. According to prominent Wellington property investor, Troy Bowker, that could impose a $4.5billion compliance cost on affected taxpayers (450,000 small businesses incurring on average $10,000 in valuation costs). The TWG specifically recommend against adopting the Australian approach of only taxing assets acquired after the date of introduction.

When will it be taxed?

- CGT would apply on a realised basis only but would be subject to a number of concessions/exclusions referred to as "rollover relief".
- Rollover relief would apply to all inherited assets, assets donated/gifted to donee organisations (charitable entities), certain involuntary events where the proceeds are invested in a similar replacement asset e.g. an insurance event/natural disaster, a business restructure where there is no change in ownership in substance, small business rollover where proceeds from included assets are reinvested in a replacement business.
- In terms of gifted assets, rollover relief would apply where the gift is to the person's spouse, de facto or civil union partner but otherwise would not qualify for relief.
- CGT will be imposed at the person's marginal tax rate. The TWG does not recommend an adjustment for inflation or that the tax rate should be discounted (as currently the case in Australia).
- The cost of an asset including capital improvement can be deducted against sale proceeds to arrive at the taxable capital gain. However, holding costs such as interest or rates will not be claimable against personal use assets.
- Capital losses should be capable of set-off against both ordinary and capital income i.e. they should not be ring-fenced and claimable against only against capital gains. However, there are several exceptions proposed to this rule - the most notable being that capital losses from personal use assets cannot be claimed against either ordinary income or capital income. Others include losses generated from associated person transactions, where rollover relief is available but the taxpayer chooses not to apply them, losses arising on assets held on valuation date.

Transitional Rules

A number of transitional rules for assets held on valuation date are also proposed including:

- Flexible and default valuation rules for valuation date assets should be mandated by Inland Revenue.
- A median rule for assets held on valuation date whereby the "cost" to be deducted from proceeds to determine the capital gain amount will be the middle value of actual cost (including improvements),

valuation date value (including improvements), and sale price. The intention is to stop artificially high valuations being adopted at valuation date.

- Transitional rules are also recommended for immigration/emigration, and where an asset changes use from private to a CGT asset and vice versa.

Who is taxed?

Consistent with our existing tax regime, a New Zealand tax resident will be subject to CGT on worldwide assets. Non-residents will be subject to CGT only on New Zealand-sourced capital gains.

Company Matters

There is some discussion dedicated to the potential for double taxation and double deductions for gains and losses in the corporate context. For example, a company sells an asset and derives a capital gain on which it is taxed. A shareholder then decides to sell their shares before that capital gain has been distributed. Inherent in the value of the shares is the capital gain derived by the company. This potentially leads to the same gain effectively being taxed twice i.e the company is taxed on realisation and the shareholder is taxed again on the same underlying gain via the increased share value.

The TWG concludes the market will take care of this issue in terms of widely-held entities and in relation to closely held entities, these issues can be managed by distributing said gains before the share sale.

Imputation continuity rules

Of particular interest is the suggestion that the continuity rules for imputation credits be removed (these rules currently require the same shareholders to hold at least 66% of the shares in a company in order to carry forward imputation credits).

Liquidation

The TWG acknowledges that the rules dealing with distributions from a company on wind-up will need to be modified to ensure pre-CGT gains are not subject to tax on final distribution.

Foreign shares

The current regime dealing with interests in foreign investment funds (FIF) is to be retained with some possible refinement to the ability for individuals and trust taxpayers to switch between the fair dividend rate and comparative value methods. However, CGT will be imposed on foreign shares which are not currently subject to the FIF regime. This includes holdings of less than 10% in Australian resident listed companies, greater than 10% holdings in Australian resident companies, and a foreign share portfolio with a cost of less than $50,000.

There is also some discussion around portfolio investment entities including KiwiSaver funds. At a very general level, the proposal is that these entities will also be subject to CGT on investments not dealt with under the FIF regime.

The Dissenting Views in the TWG

Robin Oliver, Joanne Hodge and Kirk Hope all disagree with the TWG's recommendation to introduce a comprehensive CGT regime. Their collective view is that the costs of introducing a CGT regime as proposed by the TWG would clearly outweigh the benefits. Such a regime would impose efficiency, compliance and administrative costs that would not be outweighed by the revenue collected. They also have concerns over the timetable to introduce the rules.

They suggest an incremental extension of the tax base over time i.e. extending the tax base on an asset-by-asset basis. In their view, an extension to the taxation of residential rental properties is the most obvious starting point.

Closing Comments

A lot will be said over the coming months about the proposed regime and, if the government is to get it across the line, we may find some areas are watered down, especially the applicable tax rate.

There is also one obvious recommendation that the TWG has overlooked entirely and it is this: we recommend Jacinda wanders down the hallway and has a quiet word with Winston to determine whether he is in support of a broad-based CGT regime. If not, the Interim and Final Reports will make for useful doorstops but that's

about all. A quick discussion could save us all a great deal of time and effort debating this issue, not to mention millions of dollars of taxpayer funds drafting legislation and undertaking the consultation process.