Taxing Capital Gains in New Zealand: Assessment and Recommendations

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Current *Ad Hoc*, Incoherent, Hybrid Capital Gains Tax Regime

- At least 25 kinds of assets and transactions are taxable—some on realisation, some on accrual, others based on imputed return
- Shares: taxation depends on intent and whether listed or unlisted, domestic or foreign
- Land: depends on intent at time of purchase (and many other rules)
- Ever evolving case law based on unclear and sometimes inappropriate precedents

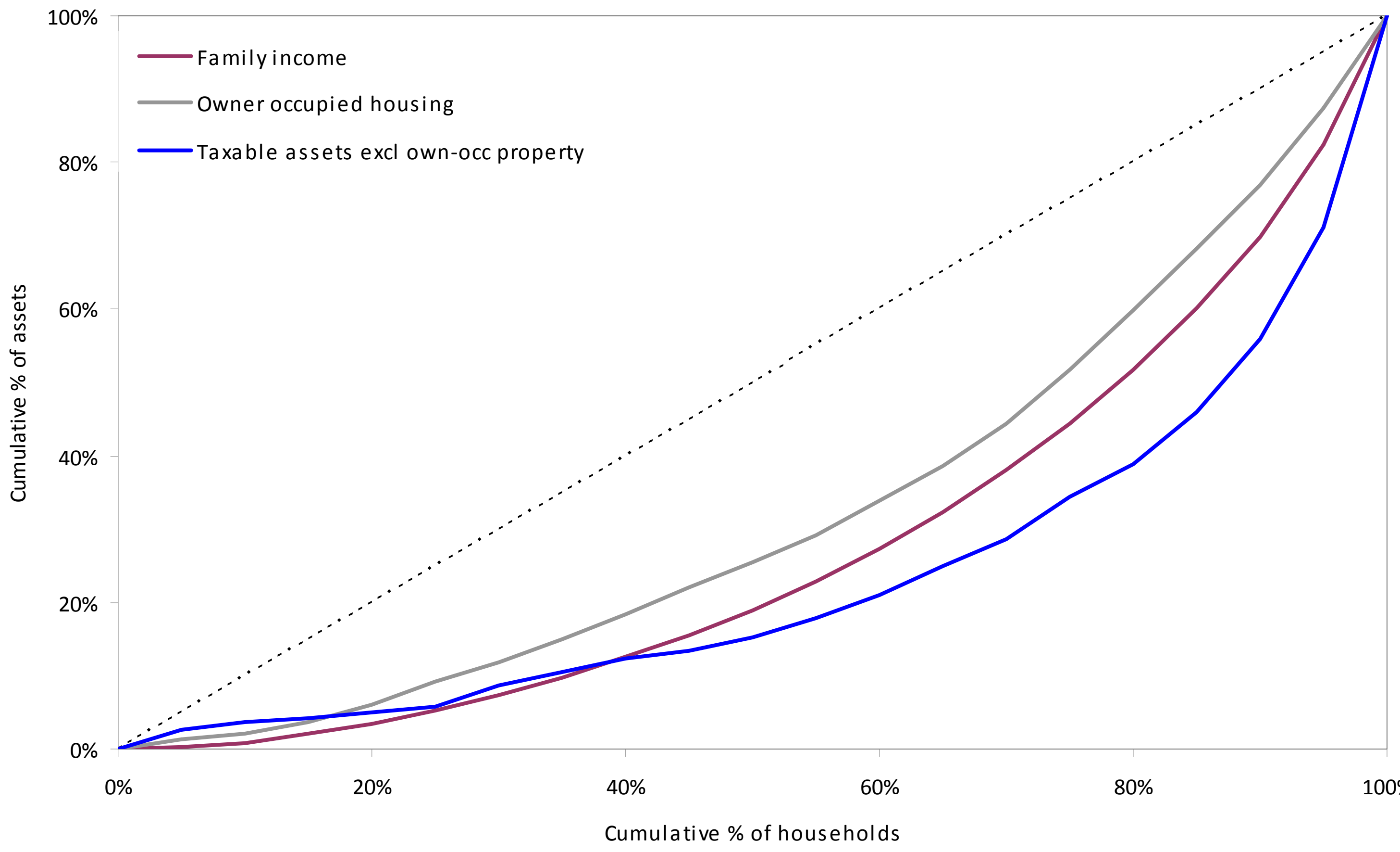
Current system is inefficient

- Distorts saving and investment decisions
- Encourages tax shelters
- Adds unnecessary uncertainty
- Reduces tax base, requiring higher rates

Inequitable

- People with equal wealth and economic income can face very different tax burdens
  - 38% tax for some, 0% for others
- Exempt assets disproportionately held by the wealthy (undermines progressivity)

Distribution of Assets and Family Income, 2006-07



Complex

- Determining boundary between capital (untaxed) and revenue can be mystifying (even to judges)
- Different taxation regimes for different asset classes/transactions
- Difficult for tax authorities to enforce

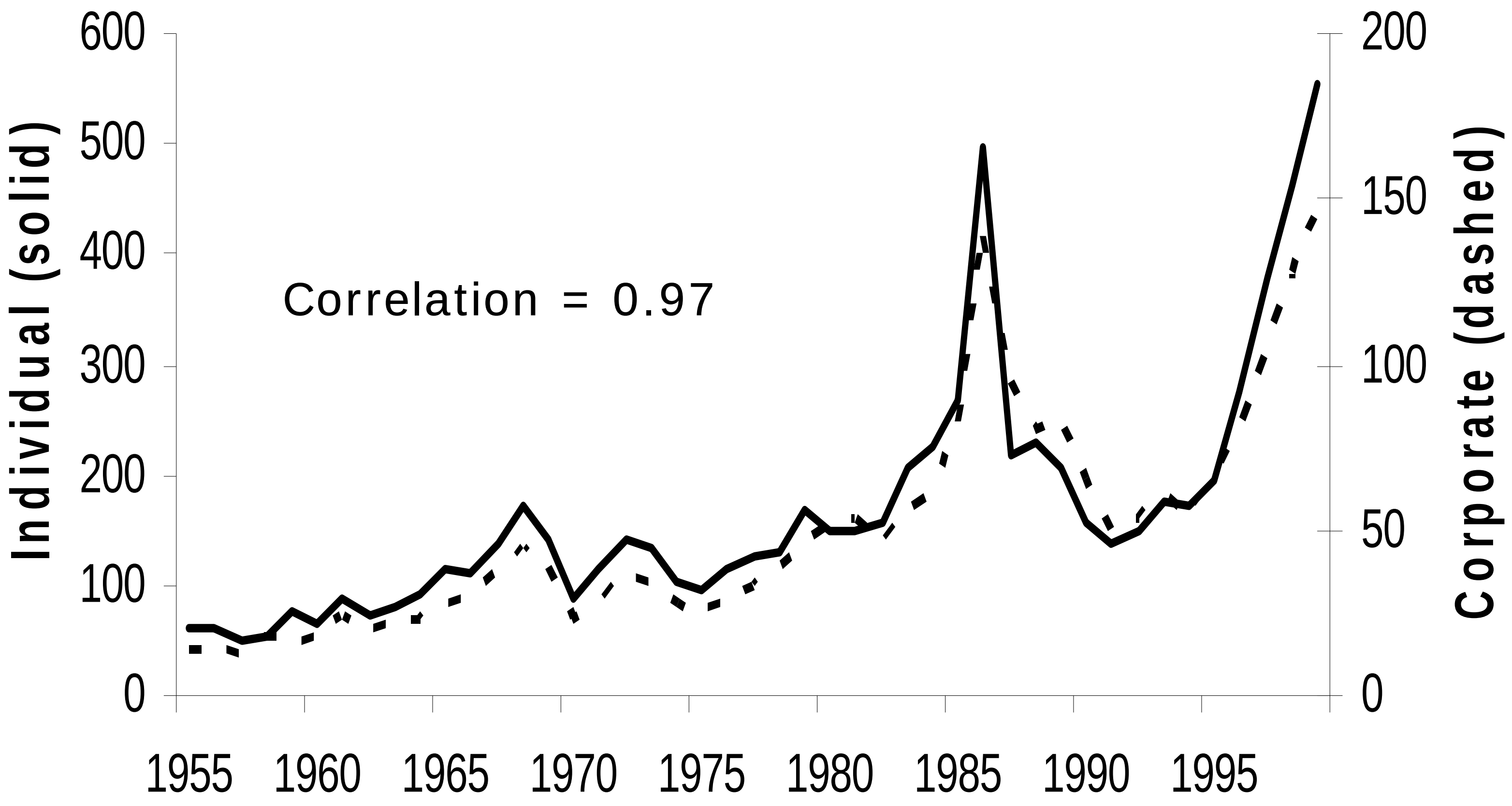
Arguments for Capital Gains Tax Relief

- The CGT creates a “lock-in effect”
- The CGT discourages risk-taking
- The CGT double-taxes savings
- Capital gains are eroded by inflation
- The CGT is a double tax on company stock

Lock-In Effect

- Realisation-based tax creates strong incentive to hold assets
- There's way more selling than one would expect, suggesting that the economic cost from lock-in might not be that great
  - "Angel of death loophole" is a big factor in US (and not recommended design feature in NZ)
- CGT preference reduces lock-in, but accrual taxation would eliminate it

Individual & Corporate Capital Gains in the US, 1955-1999, in billions of $1999



Accrual Taxation and Risk

- Let $R=r+p+e$
  - r = riskless rate
  - p = risk premium
  - e = random component (risky part)
- Investor is indifferent between asset paying r with certainty and R with risk
  - That is, p just compensates the investor for assuming the risk of e
  - Expected utility of $p+e$ is zero
- Thus tax on $p+e$ incurs no economic burden

Realisation based tax a mixed bag for risky assets

- Deferral lowers effective tax rate, especially for assets with high expected R
- Loss limits reduce expected after-tax returns for risky investments relative to others
- Evidence from US (Poterba, ABS)
  - loss limits not much of a constraint
  - (probably more binding now)
- (Is there not enough risk taking?)

Double taxation of saving

- Valid complaint, but…
- It’s an argument for consumption tax, not preferential treatment of only some returns to saving
- Theory of second best and tax shelters

Inflation

- Inflation reduces real after-tax return on assets—can even turn it negative
- But appreciating assets affected less than others (like bonds)
- Indexing taxation of *all* capital income and expense would, in principle, make sense
  - However, it would complicate administration and compliance and probably not worth the cost at low inflation
- Indexing capital gains without indexing capital expense is a recipe for tax shelters

Corporate double tax

- New Zealand’s corporate tax is integrated with individual income tax so this is not a significant problem
  - If credits allowed against dividends, unused credits may be carried over and are presumably capitalised in asset values, increasing gains.

Issues with Accrual Taxation

- It’s the theoretical ideal under unrealistic assumptions—and possibly impediment to real world reform
- Measurement issues
- Liquidity
- Volatility of income tax receipts
  - Shifts risk from individuals to government
  - Automatic stabiliser

A Better Hybrid Regime

- Accruals taxation for listed shares and unit trusts
  - Company tax allowed as credit against accrued gains
  - Full deductibility of losses
- RFRM tax at full rate for other assets
  - Economically equivalent to accruals taxation, but could be very hard to explain to non-specialists

Realisation based tax

- Expand capital gains net to include all capital assets
- Tax assessed on sale (realisation)
  - This is the norm in the rest of the OECD
- Losses may be deducted only against gains; net losses carried over
  - Evidence from US suggests that carryovers do not persist in normal times
- Partial exemption for owner-occupied housing
  - Small property tax to offset bias in favor of homeownership

Design issues in realisation-based tax

- Transition
  - Canadian approach—gains after “valuation date” subject to tax—diminishes lock-in problem
- Exemption for small gains?
  - A small exemption (e.g., $500 per year) could spare most taxpayers from the tax while preserving most of the base
  - Disregard could also be applied for eligibility to means-tested transfers
- Taxing lumpy gains
  - Australian approach
- Holding period requirement for housing exemption
- Rollovers
  - M&A and certain corporate restructuring allowed rollover relief
  - Rollover relief for real estate is a bad idea (although in place in US)
- Taxation at death

Tax rate on gains

- Most countries exclude a portion of gains from tax (US applies separate rate schedule, which is very complex and not recommended)
- With accruals taxation, there would a strong argument for taxing gains in full on equity and efficiency grounds
- Even with realisation-basis tax, full taxation simplifies administration and compliance considerably and is a good solution of individual income tax rates are not too high
  - USA--TRA86: top rate of 28% applied to all income
- However, if lock-in and the ring fencing of losses are judged to be significant problems, they can be mitigated by excluding a portion of gains from tax
  - Optimal exclusion balances efficiency and equity gains from taxing gains against the efficiency costs due to lock-in, loss limits

It is extremely unlikely that the optimal CGT rate is zero

Effects of broadening the taxation of capital gains

- Improves efficiency
- Raises revenue
- Progressive: Could offset effect of other regressive (but efficiency-enhancing) tax changes such as rate cuts, GST increase
- More rational system easier for taxpayers to comprehend, comply with, and for authorities to administer
- NZ tax system brought more in line with OECD norms

Conclusion

- No perfect solution given real world constraints
  - Should not let perfect be the enemy of the good
- Our judgment is that taxing capital gains more like other income would enhance efficiency and fairness