Tax Tips Alert
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The Tax Working Group – Final Report

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The Tax Working Group (the Group) has released its final report (the report), containing close to 100 specific recommendations across a broad spectrum of New Zealand's tax system.

Generally, the recommendations are consistent with those outlined in the Interim Report released last September. The introduction of a broad capital gains tax is the Group's most notable "new" recommendation, and is likely to come as no surprise to anyone following discussions in the media. The report provides a roadmap as to how the Government may want to design a broad capital gains tax. The Group has also refined a number of other recommendations including more detailed analysis of how the New Zealand tax system may be used to combat environmental challenges facing New Zealand.

The Government's next step is to consider the report and decide which of the recommendations to adopt. Ministers have indicated that the Government's full response will be released in April 2019 at which time New Zealand will have a clearer picture of the tax changes that will result from the Group's work. The Government still intends to pass legislation to implement any policy changes arising from the report before the end of the current Parliamentary term. However, consistent with their political commitment, any new capital gains tax would not take effect until 1 April 2021. To meet this ambitious timeframe, draft legislation will need to be introduced before the end of the year.

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Summary of key recommendations

Extending the taxation of capital gains – the road map

What will be taxed?

- As recommended, a broad capital gains tax will include gains on all land and improvements (except the family home), shares, intangible property, and business assets. Personal use assets (such as cars, boats, or other household durables) are excluded. Some types of transactions relating to collectively-owned Māori assets may potentially be excluded.
- Only gains and losses that arise after the implementation date (Valuation Day) will be taxed.
- The Valuation Day approach will require taxpayers to establish a market price on Valuation Day to form the "cost base" of assets. Taxpayers will have five years to determine the market value on Valuation Day. If this is not done, then a default rule will apply.

When will the tax apply?

- Tax will be imposed on a realisation basis in most cases.
- Rollover relief will be available for certain life events (e.g. death and relationship separations), business reorganisation, and small business reinvestments.
- The report recommends maintaining the status quo for foreign shares taxed under the Fair Dividend Rate regime and debt instruments taxed under the financial arrangements rules.

How will the tax apply?

- All capital gains should be taxed within the current tax system at the taxpayer's marginal rates (i.e. not a separate regime).
- There will be no discount and no adjustment for inflation.
- Capital losses should generally be treated in the same way as other losses i.e. should be able to offset against other types of income.
- Ring-fencing of capital losses for portfolio investments in listed shares (other than when they are trading stock), associated party transactions, and losses from Valuation Day assets (no ring-fencing would apply for assets purchased from third parties after Valuation Day).

Environmental taxes

- The Group finds that there is significant scope for the tax system to play a greater role in sustaining and enhancing New Zealand's natural capital. Tax is one tool that should be used alongside regulation and spending measures to help our environmental challenges and transition New Zealand's economy to a sustainable basis.
- In the short-term – better use of environmental taxes to price negative environmental externalities. Immediate priorities include:
  - expanding coverage and rates of the Waste Disposal Levy
  - strengthening the Emissions Trading Scheme (ETS) by greater price guidance of emissions units (NZUs), increasing the use of auctioning NZUs, and ensuring all emissions face a price, including agriculture, either via ETS or a complementary scheme
  - advancing the use of congestion charging.
- In the medium term – environmental tax revenue could be used to fund transition to a more sustainable economy.
- In the longer term – environmental taxes could play a more significant role in the New Zealand tax base including the development of innovative tools to comprehensively measure the impact of activities on natural capital, including resource use.
- The Group recommends strengthening the environmental tax capabilities of Government including those of the Parliamentary Commissioner for the Environment.
- The Government should review the use of concessions including:
  - implementing new environmentally friendly concessions e.g. allowing employers to subsidise use of public transport without FBT
  - reviewing current specific tax concessions e.g. farming, forestry, and petroleum mining – with a view to remove them if they are harmful to natural capital.

Taxation of business

- Business taxation is generally sound. Therefore, the Group has not recommended any significant changes to the general structure of the current rules (e.g. the imputation credit regime, the current company rate for all companies, and current Māori Authority rate should all be maintained).
- The Group does recommend a number of technical changes, such as:
  - changes to the loss continuity rules to support innovative start-up firms
  - reforming the tax treatment of black-hole expenditure including:
    - recognising expenditure incurred by a business that is not currently dealt with (e.g. abandoned projects and assets)
    - allowing black-hole expenditure to be deducted over five years but with clawback available if the abandoned assets or project are subsequently restored (and deductions are capitalised)
    - allowing a $10,000 safe harbour deduction for feasibility expenditure.
  - restoring depreciation for buildings if a capital gains tax is introduced (although this is likely to be on a partial basis due to fiscal constraints). Options for restoring depreciation:
    - seismic strengthening only;
    - include multi-unit residential buildings; or
    - all industrial, commercial, and multi-unit residential buildings
  - introducing a specific regime that encourages investments into nationally significant infrastructure projects.
- A number of compliance savings measures have also been recommended – suggestions for immediate action include increasing the threshold for provisional tax to $5,000, increasing the closing stock adjustment from $20,000 to $30,000, increasing the automatic deduction for legal fees and consider expanding to other types of professional fees.
- In relation to international taxation, the Government should be ready to implement equalisation tax on digital services if it is implemented by the majority of other countries and the Government can be "reasonably certain" that New Zealand's export industries will not be materially impacted by retaliatory measures.

Retirement savings

- The Group does not recommend any significant changes to the taxation of savings but does recommend increasing tax benefits via KiwiSaver for low and middle income earners to encourage more savings, including:
  - refunding Employer Superannuation Contribution Tax for KiwiSaver members earning up to $48,000 a year and ensuring members on parental leave would receive the maximum member tax credit regardless of their level of contributions
  - increasing the member tax credit to $0.75 per $1 of contribution (although retaining the contribution cap at current levels)
  - reducing the lower PIE rates for KiwiSaver funds (10.5% and 17.5%) by five percentage points each
  - simplifying the determination of the PIE rates which would apply to KiwiSaver.
- The Group does not consider it necessary to adjust for inflation but does recognise the need for more work to develop options to maintain the purchasing power of savings through retirement.

Personal income tax

- If the object is to improve incomes for very low income households then using welfare transfers is the best way to achieve this. Changes to personal income tax is a better option if the goal is to improve incomes for certain groups of low to middle income earners e.g. full-time workers on minimum wage.
- The Group recommends increasing the threshold for the bottom tax bracket rather than introducing a tax-free threshold. A threshold increase for the bottom tax bracket should be combined with an increase in the second marginal tax rate to improve progressivity.
- The Government should consider increasing net benefit payments so that beneficiaries receive the same post-tax increases as other people on the same income.
- The Group does not recommend reducing the top personal tax rate – New Zealand's top personal tax rate is already low by international standards and a reduction would not improve progressivity.
- The Group notes that the recommended changes will have minimal impact on income inequality. If the Government wishes to make a significant impact, it will need to change the top personal tax rates, which is outside the scope of the Group's Terms of Reference.

Future of work

- The following two recommendations require significant attention by the Government:
  - more efforts to increase the compliance of the self-employed, including the use of technology platforms to assist the self-employed to meet their tax obligations
  - extending withholding taxes as far as practicable (including platform service providers such as ride sharing companies) so long as it does not impose unreasonable compliance costs.
- Other recommendations include reviewing GST requirements for contractors who are akin to employees and aligning the definition of employee and dependent contractors for tax and employment purposes.

Integrity of the tax system

The Group recommends:

- strengthening the enforcement of rules for closely-held companies (due to the difference between the company tax rate and the top personal tax rate).
- placing a greater focus on the hidden economy, including an increase in the reporting of labour income and the removal of tax deductibility if a taxpayer does not comply with any labour income withholding or reporting rules.
- providing more enforcement rules for Inland Revenue, including making directors who have an economic ownership in the company personally liable for arrears in GST or PAYE where there has been persistent or deliberate non-compliance, and introducing departure prohibition orders where there are tax arrears.
- establishing a single Crown debt collection agency.
- reviewing loss trading, potentially in tandem with a review of loss continuity rules for companies.

Administration of the tax system

Suggestions to improve the administration of the tax system include:

- Better use of data, including a review to determine if current data collected offers the most useful insights, or whether other data sets would better respond to the needs and interest of the public and future policy development (e.g. better data on distribution of wealth).
- Establishment of a taxpayer advocacy services to provide assistance with the resolution of tax disputes, and consider truncating the disputes process for small taxpayers.
- More tax resource for the Office of the Ombudsman to carry out its function in relation to tax.

Charities

- The underlying issue is how charities are distributing or applying surpluses from business activities for their charitable purposes. Therefore, the Group recommends periodic reviews of the charitable sector's use of what would otherwise be tax revenue to verify that the intended social outcomes are being achieved.
- The Government should consider whether there needs to be a distinction between rules for privately-controlled charitable foundations and trusts and other charitable entities, noting that the current rules appear to be "unusually loose" for privately-controlled foundations.

GST and financial transaction taxes

- The Group recognises public concerns about regressive-nature GST but believes improved progressivity in the tax system can be better achieved via transfers or reductions in personal tax rates and so the Group does not recommend a reduction in the GST rate.
- There is a strong in-principle case to apply GST to financial services but the Group did not identify any feasible options to tax the consumption of financial services.
- The Group does not recommend introducing a financial transaction tax but the Government should monitor international developments.

Corrective taxes

- The Group does not recommend any new corrective taxes or any increase in current rates.
- The Group recommends the development of a framework for deciding when to apply corrective taxes.
- The rate structure of alcohol excise taxes should be reviewed but the Group does not make any recommendations in relation to rates of excise (as it is not the Group's area of expertise).
- The Group is concerned with the distributional impact of further increases to the excise on tobacco other than those already signalled. Therefore, the Group recommends the Government should consider other measures.
- The Government's goals regarding sugar consumption and gambling activity needs to be more clearly articulated. For example, if the goal is to decrease the consumption of sugar generally then sugar tax may be effective. However, if the goal is to reduce the sugar content of particular products then regulation is likely to be more effective.

Housing

The Group recommends:

- repeal of the ten-year rule regarding selling for a gain caused by changes in land use regulation
- disclosure of the purchaser's IRD number on the Land Transfer Statement should be required when purchasing a main home, and
- further consideration of vacant land taxes. However, such a tax would be best levied as a local tax rather than a national tax.

Package of tax reforms?

After the release of the interim report, the Ministers asked the Group to consider the potential design of revenue-neutral packages - some of which might reduce inequality.

The main starting point of the packages takes into account the additional revenue from extending capital gains taxation. Specifically, the introduction of a broad capital gains tax (as recommended by the Group) is projected to raise $8.3 billion over five years and that figure is expected to increase over time (rising to a long-run average of 1.2% of GDP per year). However, the revenue generated can be volatile. From there, the packages incorporate a mixture of the report's other recommendations – some of those measures will be revenue-raising while others are revenue-reducing.

The Group designed four illustrative packages:

- A package that increases progressivity through reductions in personal income tax
- A package with a greater focus on measures to support businesses and housing affordability
- A package with a greater focus on supporting savers, particularly those on lower incomes
- A package with a more diversified focus where business tax measures are deferred to enable greater savings measures.

While each package focusses on a different theme, they all involve modest reductions in personal income tax to deliver the greatest proportional benefits to lower income earners. By way of example, package two has a business and housing focus:

Package 2: Business and housing focus

Personal income tax reductions	Savings measures	Business tax and housing measures
$3.9 billion • Increase bottom personal income tax threshold to $20,000 from 1 April 2023	$1.8 billion • ESCT exemption for those earning less than $48,000 • Reduce lower PIE rates for KiwiSaver by five percentage points • Enable primary caregivers to receive full member tax credits during maternity regardless of contributions	Business tax measures $1.7 billion • Reintroduce depreciation deductions for commercial and industrial buildings (1% DV rate) • Enable deductions for black-hole expenditure • Reduce restrictions on loss continuity Housing measures $1 billion • Reintroduce depreciation deductions for multi-unit residential buildings (1% DV rate) • Remove residential loss ring-fencing

It will be up to the Government to decide how best to use the revenue collected from the introduction of a broad capital gains tax. The four illustrative packages provide some indication, at least, as to what a package with a particular focus may look like.

What's next?

We are expecting the Government's full response to the Group's report in April. We expect there will be significant discussions between the coalition parties during this time on what, if any, of the recommendations should be adopted.

In particular, we await with great interest the Government's decision on the Group's recommendation to introduce a broad capital gains tax. One potential outcome could be that the Government adopts the Group's minority view and extends capital gains tax to residential rental investment properties only. Another option could also be a phased approach for different assets.

One aspect of the report, which the Government has already progressed with, is the commitment to issue a discussion document on how New Zealand may update its international tax framework to ensure the digital economy is included. However, the Government's preference is still to continue working with the OECD for a global solution, consistent with the Group's recommendation.

We understand the Government's intention is to pass legislation implementing any policy changes from the report before the end of the current Parliamentary term. Based on that timing, we would expect draft legislation to be introduced to Parliament before the end of this year.

Assuming the Government adopts the recommendation to introduce a broad capital gains tax, passing legislation before the next election is a very ambitious and risky timeframe. It will be critical that legislative changes are subject to the Generic Tax Policy Process to give New Zealanders the opportunity to contribute and comment on such significant tax reforms. There is a risk that the quality of the legislation could suffer because of the compressed time frame. Other jurisdictions around the world have taken years to get their capital gains tax regimes working well. It may be prudent to take more time in the design and consultation of any draft legislation to ensure the final product achieves the Government's policy objectives.

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