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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

Simon James¹ and Andrew Maples²

Abstract

It is unusual to find a tax in operation which does not represent a compromise between tax principles, policy and administrative considerations. However, the third of these, tax administration, often does not receive the attention it should as proposals for tax reform are developed. This paper examines one particular case, the possibility that attempts to introduce a capital gains tax (CGT) in New Zealand (NZ) have been unsuccessful because the right balance between the three dimensions of tax reform has not been achieved and that for this and other possible reforms each of these aspects should be given the appropriate consideration. New Zealand does not currently have a comprehensive CGT. In fact, political commentators have long said that the enactment of a CGT in NZ would be ‘political suicide’. The reasons for such antipathy towards a CGT are not entirely clear especially given the successful implementation and operation of CGT in many jurisdictions, including the United Kingdom (UK). However, sentiment towards a CGT in NZ appears to have softened more recently. Perhaps sensing this rise in support, the centre-left New Zealand Labour Party in the 2011 and 2014 general elections unsuccessfully campaigned on, inter alia, introducing a comprehensive CGT. It is unclear what part the CGT proposal played in its defeat in both elections with other factors in play. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has indicated that reform of the NZ tax system, including a possible CGT, would not be made ‘without going to the people first and getting a mandate to do so’.³ Accordingly, the electorate support for a CGT, and its design (including the administration of the tax), will be crucial for its political viability in NZ; hence the rationale for this paper. The paper finds that the UK CGT is a very robust tax but has never taken a pure form based only on the principles of good tax design. Indeed its success in tax policy terms has been largely accounted for by pragmatic modifications over the years to accommodate the different and changing political and economic pressures applying to modern tax systems. The paper concludes that a more pragmatic approach could lead to the design of a CGT that may gain the broad support of the NZ electorate and also be as enduring as it has been in the UK.

Keywords: capital gains tax, tax administration, tax policy, tax principles, sustainability, tax compliance

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³ ‘Little, Robertson Confirm Labour’s Ditched Policies and Reveal Some New Ones’, *The National Business Review* (online), 7 November 2015 <http://www.nbr.co.nz/article/little-robertson-confirm-labours-ditched-policies-and-reveal-some-new-ones-ng-181292?utm_source=newsletter&utm_medium=email&utm_campaign=NBR%2520Heads%2520Up>

1. INTRODUCTION

It has been suggested that tax administration has not been given sufficient attention in the voluminous literature on tax reform⁴ although its importance is clear and acknowledged, for instance, in their part of the Mirrlees Review⁵ by Shaw et al. who stated: ‘administration and enforcement are often neglected in tax policy, but they are central to making a tax system work’.⁶ Tax administration covers a range of aspects of taxation. One view seems to be that it is concerned only with the implementation, management and enforcement of existing tax legislation and other regulations. However, some authorities have taken a wider view. For example, Gordon’s analysis⁷ is developed in terms of the law of tax administration and procedure while USLegal notes that the term ‘tax administration’ has also been used to include the development and formulation of tax policy relating to tax legislation and related regulations.⁸ Mansfield observes that ‘tax administration is a loosely defined area that embraces law, public administration, sociology, and psychology as well as economics’.⁹

In developing tax design the natural place to begin is with tax policy as it reflects government aims and objectives but these should take into account tax principles and practice in the form of tax administration. In this context the term ‘tax principles’ refers to criteria such as equity and efficiency which may be used to assess existing taxes or proposed tax reforms.¹⁰ Although tax principles are a valuable guide to tax design, the optimal outcome might require modification in the light of tax policy and the reality of tax administration. As already indicated, tax administration should also be considered but administrative solutions should take account of both policy and principles. Figure 1 illustrates the view that all three dimensions interact and each should take account of the other two.¹¹

⁴ See, for example, Richard M Bird, ‘Administrative Constraints on Tax Policy’ in Cedric Sandford (ed), *Further Key Issues in Tax Reform* (Fiscal Publications, 1998).

⁵ Sir James Mirrlees (Chair), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010).

⁶ Jonathan Shaw, Joel Slemrod and John Whiting, ‘Administration and compliance’ in Sir James Mirrlees (Chair), *Dimensions of Tax Design: The Mirrlees Review* (Oxford University Press, 2010) 1100–162.

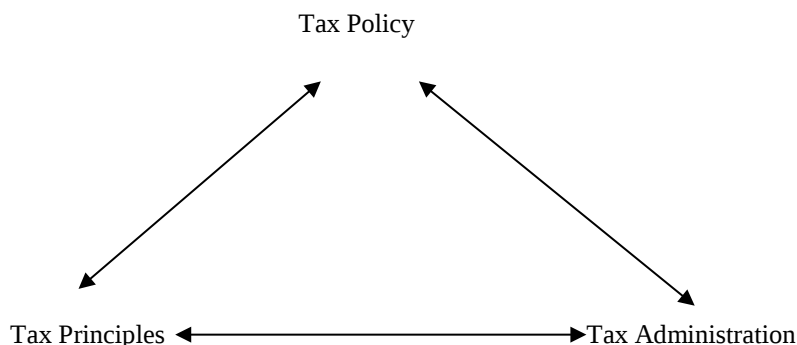
⁷ Richard K Gordon, ‘Law of Tax Administration and Procedure’ in Victor Thuronyi (ed), *Tax Law Design and Drafting* (International Monetary Fund, 1996) vol. 1 ch. 4.
<<https://www.imf.org/external/pubs/nft/1998/tlaw/eng/ch4.pdf>>.

⁸ US Legal, definition <<http://definitions.uslegal.com/t/tax-administration/>>.

⁹ Charles Mansfield, ‘Tax Administration in Developing Countries—An Economic Perspective’ *Staff Papers* (International Monetary Fund, 1988) vol. 35, 181.

¹⁰ In his definitive work, *An Inquiry into the Nature and Causes of the Wealth of Nations* (Pt 2, Ch 2, Bk 5), (William Benton, 1952), 361–62, Adam Smith identified four principles or maxims (equity, certainty, convenience and freedom from economic burden) with regard to taxes in general which have been a starting point for evaluating a tax. More modern commentators have tended to condense these four criteria into the three mentioned above (equity, efficiency and simplicity): Gordon Cooper, Chris Evans and Kirk Wilson *Australian CGT Handbook 2014–2015* (Thomson Reuters, 2014), 13. For a discussion of these principles see Cooper, Evans and Wilson, 13–16. James and Nobes define tax principles primarily in terms of equity and efficiency: Simon James, and Christopher Nobes, *The Economics of Taxation: Principles, Policies and Practice* (Fiscal Publications, 2016).

¹¹ The authors would like to thank David Guttormsen for his comments that led to the development of this diagram.

Figure 1: The Interdependence of Tax Policy, Principles and Administration

The UK experience is that all three have an important role in the design, reform and operation of CGT and it is not easy to separate out each aspect with regard to individual features of the UK CGT. Often all three are involved and sometimes in more than one way. The relationship between the three is therefore a close and complex one. With respect to the recent proposal by the New Zealand Labour Party (Labour) for the introduction of a CGT in NZ, the UK experience over a period of fifty years is that all three should be carefully considered.

In addition, and related to, the above three dimensions, the Victoria University of Wellington Tax Working Group (TWG) (and others) highlight the need for any tax reform (and a tax system) to be politically sustainable.¹² This not only requires tax reform to be supported by voters but ‘that the tax system be designed to minimise vulnerability to interest group pressure and political temptation to tamper with or reverse the critical elements of a coherent system’.¹³ As a cautionary note, the TWG continue: ‘[p]iece-meal changes to the [NZ] tax system have undermined the integrity, acceptability and political sustainability of the system. It is important to bear this lesson in mind when considering ... base-broadening options’.¹⁴ In terms of CGTs specifically, Quintal, Snell and Chan warn that from a legislative perspective, CGTs ‘tend to be particularly unstable’.¹⁵

In considering tax reform and the tax system generally, it is also important to acknowledge the impact of self-assessment on tax administrations and taxpayers. Under self-assessment the role of the revenue authority is more focussed on audit. For taxpayers, in the context of CGT, self-assessment requires them to determine if it applies to them and the amount of that tax obligation. Thus, while a concession such as a tax-free threshold may reduce both the CGT’s application (and therefore enhance its political sustainability) as well as revenue authority audits (tax administration),

¹² Centre for Accounting, Governance and Taxation Research, *A New Tax System for New Zealand’s Future, Report of the Victoria University of Wellington Tax Working Group* (Wellington, January 2010) 10, 64. Nobel prizewinner James E. Meade wrote: ‘I am an economist and have tried to give you an economic solution for an economic problem. Please do not argue that I am a rotten economist on the grounds that the economic solution is politically unacceptable’: James E Meade, ‘Stagflation in the United Kingdom’ (1979) 7 *Atlantic Economic Journal*, 9.

¹³ Ibid 64.

¹⁴ Ibid.

¹⁵ Aaron Quintal, David Snell and Nicholas Chan ‘Key Issues In The Design Of Capital Gains Tax Regimes: The Impact On Tax Practice [Part 2]’ (October 2015) *Taxation Today* 19.

taxpayers must determine and calculate the capital gain to validly apply the concession (and are therefore subject to increased compliance costs). For some taxpayers this will be straightforward. In other cases, where for example a person has been involved in multiple asset sales in a year, this will be a time-consuming exercise.

To define income, the authors in this paper adopt the concept of ‘comprehensive income’, also known as the Haig-Simons concept of income. Comprehensive income for a period represents the difference in wealth between the beginning and end of the period, together with consumption during the period. As such all gains (realised and unrealised) are income and should be taxable on a periodic (for example, annual) basis. Harris et al. observe:

It should be stressed that that the notion of comprehensive income is a theoretical concept that can never be fully achieved under any real-world income tax. Among other things, implementation of a comprehensive income tax would require measuring on an accrual basis the annual change in value of every asset and liability of every taxpayer. Instead, the concept is best regarded as a benchmark against which the properties of our income tax, and of potential changes to it, can be assessed.¹⁶

Acknowledging that the concept is a benchmark, departures or modifications are made for a variety of (often inter-related) reasons, including:

1. Tax policy and principles
2. Practical issues, such as (under an accrual-based system) the difficulties of valuing assets and lack of cash to pay the tax
3. Tax administration, including the inability of the revenue authority to verify a gain
4. Tax compliance
5. Complexity of the application of the tax for taxpayers and the related costs to comply
6. Political sustainability, in respect of a particular tax reform and the tax system generally.

The discussion in this paper focusses on departures or modifications from the Haig-Simons definition of income based on tax administration, tax policy and tax principle considerations. In addition, as already indicated, the need for tax reforms to be politically sustainable impacts on, and interacts with, these three considerations.

By way of background to this paper, NZ operates a broad-base, low rate (BBLR) tax system, which includes an income tax for individuals with four tax rates (and a low top tax rate of 33%),¹⁷ and a comprehensive goods and services tax (GST).¹⁸

¹⁶ Garth Harris, Chris Ohms, Casey Plunket, Audrey Sharp and Nigel Smith, *Income Tax in New Zealand* (Brookers Ltd, 2004), 41–2.

¹⁷ Perhaps unusually compared with countries such as the UK and Australia there is no tax-free threshold.

¹⁸ NZ does not have (i) an inheritance tax, (ii) local or state taxes apart from property rates levied by local councils and authorities, (iii) a payroll tax, (iv) social security tax, or (v) a health care tax, apart from a very low levy for New Zealand’s accident compensation injury insurance scheme.

However, the country is unusual among Organisation for Economic Development and Cooperation (OECD) countries as it does not have a comprehensive capital gains tax (CGT).¹⁹ Rather, certain specified capital gains are taxed in the *Income Tax Act 2007* (NZ). Despite various committees considering the implementation of a CGT in NZ, admittedly with differing conclusions,²⁰ and overseas bodies such as the OECD²¹ noting the benefits of a CGT for the NZ economy, there has been a longstanding antipathy against adopting the tax. While more recently sentiment may have softened among some business leaders and politicians,²² more will be required in order for any proposal for a CGT to be supported by the electorate.

The remainder of this paper is structured as follows: Section 2 considers, by way of background, the possible reasons for the hostility towards a CGT in NZ, in part to inform decisions concerning the design of a future NZ CGT. The recent moves by Labour to promote such a tax are also noted in this section. Section 3 provides an overview of the UK's experience with a CGT. Section 4 outlines and critiques key aspects of Labour's CGT policy set against the UK experience and in the context of the strength of feeling against a NZ CGT. The purpose of this section (and the paper) is not to evaluate Labour's CGT proposal comprehensively,²³ nor is it the authors' intention to design a CGT for NZ. Rather, in the context of the UK CGT, the authors' aim is to illustrate the interplay between tax administration, tax design and tax principles and how this interplay may lead to a more palatable and politically sustainable CGT policy for NZ. Concluding comments and observations are made in Section 5.

2. ANTIPATHY IN THE ANTIPODES—NEW ZEALAND AND CAPITAL GAINS TAX

2.1 Why the angst?

As indicated in Section 1, NZ has adopted a BBLR tax framework; one that politicians and policymakers are quick to extol.²⁴ However, claims that without a CGT NZ is operating under such a framework are somewhat debateable. The arguments in

¹⁹ Cooper, Evans and Wilson observe that among OECD countries NZ is 'the notable exception' without a CGT: Gordon Cooper, Chris Evans and Kirk Wilson *Australian CGT Handbook 2015–2016* (Thomson Reuters, 2015), 11. Further, based upon the IBFD Tax Research Platform, 167 countries out of 219 had a CGT system in place: *ibid* 11.

²⁰ See for example, Melinda Jacomb, 'A History of taxing Capital Gains in New Zealand: Why Don't We?' (2014) 20 *Auckland University Law Review* 124, 131–44.

²¹ See, for example, in its June 2013 economic survey of NZ, the OECD highlighted the lack of a CGT as a weakness in the NZ tax policy framework and stated that a CGT could, along with other tax changes, 'facilitate a more efficient and equitable tax structure'; OECD, *OECD Economic Surveys: New Zealand* (OECD Publishing, 2013) 24.

²² See, for example, Ben Chapman-Smith, 'Capital Gains Tax No Good Unless Comprehensive—English', *The New Zealand Herald* (online), 25 July 2013; Thomas Pippas, 'Capital Gains Tax An Inevitable Part Of The Future Landscape', *The New Zealand Herald* (online), 23 July 2013; Jamie Gray, 'Labour's Tax Plan Centre Stage For Our CEO's', *The New Zealand Herald* (Auckland), 12 September 2014, <<http://www.nzherald.co.nz/mood-of-the-boardroom/news/print.cfm?objectid=11322939>>.

²³ See, for example, Andrew 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 *New Zealand Journal of Taxation Law and Policy* 144.

²⁴ See, for example, Hon Todd McClay, Speech (Chartered Accountants Australia and New Zealand Tax Conference, 31 October 2014) <<http://taxpolicy.ird.govt.nz/news/2014-10-31-address-caanz-tax-conference#speech>>.

support of a CGT in NZ (such as equity²⁵ and efficiency)²⁶ have been well canvassed as have the flaws in the current income tax system in the absence of such a tax.²⁷ While some review committees have supported the implementation of a CGT in NZ,²⁸ it has been a long held belief that the enactment of a comprehensive CGT in NZ would be '[a] sure-fire path to political suicide'.²⁹ Former Prime Minister, the Rt Hon David Lange reputedly characterised 'a capital gains tax policy as one likely to lose you not merely the next election, but the next three'.³⁰ Interestingly, the closest NZ has ever come to comprehensively taxing capital gains was under the reformist fourth Labour government, which was led by Lange until 1989.³¹

The strength of feeling against a CGT is curious to those outside NZ, including one of the authors of this paper, given that CGTs have been implemented around the world, including the UK and, more recently, South Africa (in 2001). On the bases of its widespread adoption and relative longevity as a tax, CGT has been successful. One of the reasons for such success is that CGT scores well in terms of the principles of

²⁵ See, for example, Alvin Cheng, Howard Davey and Keith Hooper, 'The Perceptions of Tax Teachers on Taxing Capital Gains in New Zealand' (2010) 16 *New Zealand Journal of Taxation Law and Policy* 217, 233.

²⁶ For a discussion of the principles in support of a CGT, see Rick Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for Institute of Policy Studies, Wellington, 1990); Paul Kenny, 'Capital Gains Taxation for New Zealand: Fairer and More Efficient' (2001) 7 *New Zealand Journal of Taxation Law and Policy* 265; Leonard Burman and David I White, 'Taxing Capital Gains in New Zealand' (2003) 9 *New Zealand Journal of Taxation Law and Policy* 355; Leonard E Burman and David I White, 'Taxing Capital Gains in New Zealand: Assessment and Recommendations' (Paper presented at session three of the Victoria University of Wellington Tax Working Group, 16 September 2009) Victoria University of Wellington Tax Working Group <<http://www.victoria.ac.nz/sacl/centres-and-institutes/cagtr/twg/>>; Craig Elliffe, 'Building a Better Bridge: The Case for Taxing Capital Gains in New Zealand' (2010) 16 NZBLQ 178.

²⁷ See, for example, Elliffe, above n 26.

²⁸ Julie Cassidy, Alvin Cheng and Sue Yong, 'Is a Capital Gains Tax the Answer to New Zealand's Tax Alchemy?' (2014) 20 *New Zealand Business Law Quarterly* 40, 41 cite as examples Paul Bevin, Avery Jack and John Jensen, *Income Maintenance and Taxation: Some Options for Reform* (New Zealand Planning Council, June 1978) [10.25]; Valabh Committee *Consultative Document on the Taxation of Income from Capital* (Government Printer, Wellington, 1989) [12.7].

²⁹ Bob Edlin 'A sure-fire path to political suicide', *The Independent* (New Zealand), 5 February 2008, 14.

³⁰ Barrett and Veal, referring to overseas experiences, conclude: '[m]emorable as Lange's aphorism may have been, its plausibility is dubious': see Jonathan Barrett and John Veal 'Equity versus Political Suicide: Framing the Capital Gains Tax Debate in the New Zealand Print Media' (2013) 19 *New Zealand Journal of Taxation Law and Policy* 91, 94, footnote 25.

³¹ Following the 1989 Budget, the then Labour Government established a consultative committee which published in December 1989 a 400-page report on taxing income from capital (Valabh Committee *Consultative Document on the Taxation of Income from Capital* [Government Printer, 1989]). Griffiths writes that the consultative committee 'did not intend a "new and separate tax on income that happens to be called "capital gain". It stated that the current exemption of certain types of capital income was not the result of an overt legislative decision. Rather, it was the consequence of judicial interpretations that drew upon concepts that had evolved in the unrelated area of trust law ... The current set of rules ... were "arbitrary" and "confused". The Consultative Committee's report did not propose a separate "capital gains" legislation. Rather there ought to be a "comprehensive and rational" analysis of the income tax legislation and the case for each exemption would be coolly analysed'..: Shelley Griffiths, 'The Game is Not Worth the Candle': Exploring the Lack of a Comprehensive Capital Gains Tax in New Zealand' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 51, 63–4. The proposal did not proceed as Labour lost the 1990 election. Instead, the Valabh Committee, which was subsequently formed to further consider the report, concluded that the first priority 'was to address existing "anomalies" and do "repairs and maintenance" on the current legislation.'; ibid 64. The comprehensive taxation of income regime was not part of the National governments policy and so the proposal did not proceed any further.

equity and efficiency. An understanding of the antipathy toward the tax in NZ, and whether Labour's proposals contain the right balance between policy, principles and administration, may aid in the development of a CGT policy in NZ.

In fact, at first sight, one of the difficulties with the various committee reports considering the introduction of a CGT in NZ as well as Labour's recent proposals is that administrative issues have been insufficiently addressed and as a consequence seen as insurmountable.³² Huang and Elliffe posit that:

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.³³

Considering the various NZ government reviews of CGT, Huang and Elliffe conclude that 'in deciding against adopting a CGT, NZ governments have not carefully and explicitly considered the experience of other jurisdictions'.³⁴

Griffiths more cautiously observes that: 'It is ... true that it is difficult to discern why New Zealand has almost uniquely chosen to not enact an overt CGT'.³⁵ In her review of the NZ tax system since the introduction of income tax in 1891, she suggests hostility to a CGT is 'no historical accident'³⁶ observing:

The opportunity for land ownership lay at the heart of the New Zealand egalitarian dream. Policy was often focussed on encouraging land ownership and disaggregating large holdings. ... At the same time, a young country needed to build up its capital base and the tax system needed to buttress that, not put capital aggregation and growth at risk.³⁷

However, Griffiths does also acknowledge the potential impact of tax administration in the CGT debate in NZ, observing that following the 1951 Tax Committee, where issues of measurement and administration were raised for the first time, '[o]ver the next 50 years, the practical problems underpinned the discussions about and rejection of the comprehensive taxation of capital gains'.³⁸

³² For the history of the CGT debate, including the findings of previous committees which have looked into a CGT for New Zealand, see further 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 *New Zealand Journal of Taxation Law and Policy* 269, 274–79; Julie Cassidy and Clinton Alley, 'Capital Gains Tax: Lessons From Across the Ditch' (2012) 18 *NZBLQ* 97, 97, 100–05, and Griffiths: *ibid* 51.

³³ Huang and Elliffe, above n 32, 304. Emphasis added.

³⁴ *Ibid* 273.

³⁵ Griffiths, above n 31, 51.

³⁶ *Ibid* 68.

³⁷ *Ibid*. Griffiths notes, for example: 'In 1922 and 1924, two general reports on taxation in New Zealand highlighted the need for the tax system not to discourage the disaggregation and growth of capital', *ibid*.

³⁸ *Ibid* 61, citing for example the Taxation Review Committee *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, Wellington, 1967).

New Zealand's experience with another new form of taxation—the goods and services tax—has been very positive³⁹ partly because it did not face serious administrative concerns. The emphasis of the policy design of the GST strongly focussed on simplicity with equity concerns being dealt with outside the GST itself (via the welfare transfer system).⁴⁰ As a consequence the GST is economically very efficient. This positive experience with a comparatively 'pure' tax, with its few exemptions, may have negatively impacted on perceptions of, and support for, a CGT. Griffiths observes: '... the experience with a very broadly based and successful goods and services tax has meant there has been a reluctance to settle for what seems like a CGT complicated by exceptions and imperfections'.⁴¹ The very success of one significant tax reform perversely may hinder the support for, and implementation, of another major tax reform—a CGT.

To the extent that tax administration concerns have impacted on the decision not to implement a CGT in NZ, as already noted it is important that any future proposal contain the right balance between policy, principles *and* administration.

2.2 A change in the mood?

Sentiment towards a CGT in NZ has softened more recently with a number of commentators as well as business and political leaders supporting (or acknowledging the need for) the introduction of a CGT.⁴² Backing for a CGT has also been evident among the wider community,⁴³ although it is arguably 'not [yet] ... to the level of popular support'.⁴⁴

Perhaps sensing this change in the mood towards a comprehensive CGT, the centre-left New Zealand Labour Party in the 2011 and 2014 general elections unsuccessfully campaigned on, inter alia, introducing a comprehensive CGT levied at a flat rate of 15 per cent. It is unclear what part the CGT proposal played in its defeat in both elections⁴⁵ with other factors in play, including (especially in 2014) an economy experiencing very strong growth. However, noting that the CGT policy may have alienated voters in the 2014 election, Labour Party leader, Mr Andrew Little has

³⁹ Hon Sir Roger Douglas, 'The New Zealand GST Policy Choice and its Political Implications' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 3.

⁴⁰ Equity concerns (including the impact of regressivity) were dealt with in a parallel system offering benefits and incentives for lower income taxpayers and families: *ibid* 6.

⁴¹ Griffiths, above n 31, 68.

⁴² See, for example, Chapman-Smith, above n 22; Pippos, above n 22; Gray, above n 22.

⁴³ A poll by Fairfax Media-Ipsos undertaken in October 2013 found 52.3 per cent believed a CGT on investment properties would help control rising house prices, up from 37.1 per cent in an August poll (although not stated, presumably also conducted by Fairfax Media-Ipsos): Michael Fox, 'Kiwis 'Ready' For Capital Gains Tax', *The Press* (Christchurch), 12 November 2013, A5.

⁴⁴ Thomas Pippos, 'Stealthy capital gains regime already in place', *Sunday Star Times* (Auckland), 11 May 2014, D11.

⁴⁵ On the role of the CGT policy in Labour's 2011 election defeat, political commentator Colin James observes: 'Whether the capital gains tax was the cause, or just opened the trapdoor through which Labour was destined to fall, is debateable. Judging by subsequent ratings in the polls, I think it was probably the latter.' Colin James, 'On a Wing and a Smile: Political Transition in National's Business-as-Usual Re-Election' in Jon Johansson and Stephen Levine (eds), *Kicking the Tyres: The New Zealand General Election and Electoral Referendum of 2011* (Victoria University Press, 2012) 65, 66 as cited in Barrett and Veal, above n 30, 94, footnote 28.

indicated that reform of the NZ tax system, including a possible CGT, would not be made ‘without going to the people first and getting a mandate to do so.’⁴⁶

Labour’s 2011 CGT proposal⁴⁷ was retained essentially unchanged as part of its 2014 tax policy.⁴⁸ The two policy statements are referred to in this paper as the ‘2011 policy statement’ and ‘2014 policy statement’. This paper primarily focusses on the 2014 policy statement as it reflects the most recent iteration of Labour’s CGT policy.

At the 2011 and 2014 general elections, the policies of the left-of-centre Green Party of Aotearoa New Zealand (Greens)⁴⁹ and the smaller Mana Party⁵⁰ also included the introduction of a CGT in NZ. On the basis that the Mixed Member Proportional (MMP) electoral system produces coalition-based governments and the Greens and Labour (at least) are likely coalition partners in a future government, a CGT in New Zealand is a distinct possibility in the medium term. Pressure on the fiscal purse from an aging population will also necessitate the exploration for alternative revenue sources (such as a CGT) for future governments.⁵¹ However, presently NZ is in a unique position. The country is not in the dire economic position it was in 1984⁵² when the incoming Labour government, led by Rt Hon David Lange, was forced to undertake major structural changes to the tax system within a short period (including the introduction of the goods and services tax). The country has weathered the 2008 global financial crisis comparatively well.⁵³ Major structural tax reform, such as the introduction of a CGT, at this time is not pressing. Further, as a late adopter of a CGT it has the advantage that it can look to the practices of other jurisdictions including the UK. Accordingly, it is timely to consider design and administration aspects of a potential CGT in NZ; hence the purpose of this paper.

Key aspects of Labour’s recent CGT proposals were chosen for comparison with the UK experience for two reasons. First, as the major party in any future coalition of the

⁴⁶ Above n 3.

⁴⁷ Labour Party, ‘Labour’s Fairer Tax System Explained’ <<http://img.scoop.co.nz/media/pdfs/1107/CGTWebdoctJuly20111.pdf>>. As recently as 24 May 2016 Labour have confirmed that a CGT is ‘not off the table’ if they win the 2017 general election and it would be considered by a working group looking at the tax system: Vernon Small, ‘Labour Explores Need For Tax Rises’, *The Press* (Christchurch), 24 May 2016, A2.

⁴⁸ Labour Party, ‘Capital Gains Tax’ (2014).

⁴⁹ The Greens tax policy has included the introduction of a CGT for a number of years: see Green Party, ‘Green Taxation and Monetary Policy Summary’ (3 February 2014) <<http://www.greens.org.nz/policysummary/green-taxation-and-monetary-policy-summary>>.

⁵⁰ The Mana Party campaigned on the introducing a CGT on all assets except the family home and Maori land, see, for example, <<https://www.kpmg.com/NZ/en/IssuesAndInsights/ArticlesPublications/Taxmail/Documents/Taxmail-issue1September2014.pdf>>.

⁵¹ In its briefing to the Minister of Finance, Inland Revenue noted in the context of broadening the tax base: ‘The largest area of non-taxation of income in New Zealand that could practically be taxed is capital gains.’ Inland Revenue, *Briefing for the Incoming Minister of Revenue—2014* (Wellington, 12 November 2014) 36 <<https://www.ird.govt.nz/resources/8/d/8d8ea8f9-53fe-4934-87c5-9094338af754/bim-2014.pdf>>.

⁵² In 1984 the fiscal deficit blew out to 9 per cent of GDP: Ian Dickson, ‘The New Zealand GST Policy Choice: An Historical and Policy Perspective’ in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 47.

⁵³ The New Zealand Treasury are forecasting economic growth to be an average of 2.7 per cent over the next five years: Audrey Young, ‘Tax cuts likely despite slower economy’, *The NZ Herald* (online), 9 February 2016 <http://www.nzherald.co.nz/nz/news/article.cfm?c_id=1&objectid=11586415>.

centre-left parties, it is probable that Labour will drive the policy design of any future CGT. The 2011 and 2014 policy statements are currently the best indication of the shape of such a tax at this point and no doubt will inform the development of any future policy. It is clear from a reading of the policy statements that they are the product of much research and analysis (even though essentially produced as part of Labour's election manifesto). Second, and related to the first point, of the political parties which have included the introduction of a CGT in their tax policy, Labour's is the most developed proposal. The next section provides an overview of the UK's experience with a CGT.

3. CAPITAL GAINS TAX IN THE UNITED KINGDOM

3.1 Overview

CGT was introduced in the UK in 1965 giving half a century of experience which may be relevant to discussion of a possible CGT in NZ. There are several interesting strands to the UK experience. First of all there are strong theoretical reasons for the introduction of a CGT on the grounds of economic efficiency and fairness and both were used to support the case for the tax in the UK. Nevertheless, a second relevant observation is that the UK CGT has never been of the pure form indicated by basic principles of good tax design. Sometimes it has moved closer to the theoretical ideal and sometimes further away indicating the importance of other factors in the development of the tax. Indeed a third point is that such changes suggest CGT is a fairly robust tax unlike, for example, the ill-fated capital transfer tax.⁵⁴ A further strand of interest in the present context is that, however close its relation to basic principles has or has not been, the UK CGT has not aroused much general opposition and what there has been is insignificant compared to the negative reaction to some other tax changes such as the introduction of the community charge.⁵⁵ Sir Thomas White once suggested that the only popular tax is one on someone else⁵⁶ and it is true that the lack of opposition to the UK CGT is partly due to it being levied on a relatively small proportion of taxpayers but even they have not generally voiced much criticism of the tax. Where significant criticism has been raised about particular aspects of the tax it has led to reform, as for instance in 2008 with the introduction of entrepreneurs' relief. This was a policy change to accommodate political pressure. Finally, the fact that there do not appear to have been any particular difficulties in administration and compliance beyond that which might be expected with a tax of this nature is an important lesson for NZ. It seems reasonable to conclude that the CGT in the UK has managed to achieve an acceptable balance between policy, principles and administration as well as reflecting political realities.

Several basic principles are relevant to developing a good tax system but the most important with respect to CGT are economic efficiency and equity together with

⁵⁴ See, for example, Alister Sutherland, 'Capital transfer tax: an obituary' (1981) 2 *Fiscal Studies* 37–51 and Alister Sutherland, 'Capital transfer tax: adieu' (1984) 5 *Fiscal Studies* 68–83.

⁵⁵ See, for example, Simon James, 'The contribution of behavioral economics to tax reform in the United Kingdom' (2012) 41 *Journal of Socio-Economics* 468–75.

⁵⁶ Sir Thomas White, 'In such experience as I have had with taxation – and it has been considerable – there is only one tax that is popular, and that is the tax on the other fellow' (debate in the Canadian Parliament, 1917).

administrative considerations.⁵⁷ Economic efficiency holds that taxes should not unnecessarily distort markets that are working well though, if there are market imperfections, there may be a case for corrective taxation. An equitable tax is one that is seen by taxpayers as fair and is consistent with distribution policy more generally. Administrative considerations include the avoidance of excessive complexity and administrative and compliance costs.

In terms of the economic principles of taxation, capital gains can have similar characteristics as the Haig-Simons definition of income. For instance, the capital appreciation of securities as a result of ploughing back profits may be seen as another form of income. In economic terms, the precise definition of income has been the subject of considerable debate among eminent economists. For Haig-Simons 'income is the money value of the net accretion to economic power between two points of time'⁵⁸. Henry Simons' comprehensive definition of income was that: 'Personal income may be defined as the algebraic sum of (a) the market value of rights exercised in consumption and (b) the change in the value of the store of property rights between the beginning and end of the period in question'⁵⁹. Hicks' definition took income as the 'maximum amount of money which the individual can spend this week, and still be able to spend the same amount in real terms in each ensuing week'.⁶⁰ The definition that seems to be increasingly accepted is that of total accretion, that is the accrual of wealth. This includes as income an individual's spending in a given period, plus any changes in net wealth. With such a definition a range of other gains including inheritances, gifts, winnings from gambling and any 'windfall' gains might be considered as income for tax purposes.

Considered in this way, if only some forms of income are subject to tax, the result may well be significant economic distortions as taxpayers manipulate their affairs for tax purposes. An important aspect is that, in the absence of a CGT, there may be a significant tax incentive to invest in 'non-productive' assets such as antiques, coins, paintings, precious stones and stamps and so on which are bought because of anticipated increases in their value, rather than for any productive purpose. On equity grounds, if capital gains are equivalent to income they should be subject to tax in the same way. The fairness argument is also a strong one because, of course, capital gains accrue very unevenly across the population. The importance of equity in the introduction of the CGT in the UK is evident from the following statement by the Chancellor of the Exchequer (Mr. James Callaghan) in 1965:

First, I begin with tax reform. The failure to tax capital gains is widely regarded, outside as well as inside the Labour Party, as the greatest blot on our existing system of direct taxation. There is little dispute nowadays that capital gains confer much the same kind of benefit on the recipient as taxed earnings more hardly won. Yet earnings pay tax in full while capital gains go free. This is unfair to the wage and salary earner. It has in the past been one of the barriers to the progress of an effective incomes policy, but now my right hon. Friend the First Secretary of State has carried this policy

⁵⁷ Simon James and Christopher Nobes, *The Economics of Taxation: Principles, Policy and Practice* (Fiscal Publications, 2015).

⁵⁸ Robert M Haig, 'The concept of income' in Robert M Haig (ed), *The Federal Income Tax* (Columbia University Press, 1921).

⁵⁹ Henry C Simons, *Personal Income Taxation* (University of Chicago Press, 1938).

⁶⁰ John R Hicks, *Value and Capital* (Oxford University Press, 1974).

forward to a point which many did not believe was possible six months ago. This new tax will provide a background of equity and fair play for his work.

Moreover, there is no doubt that the present immunity from tax of capital gains has given a powerful incentive to the skilful manipulator of which he has taken full advantage to avoid tax by various devices which turn what is really taxable income into tax-free capital gains. We shall only make headway against avoidance of this sort when capital gains are also taxed.⁶¹

So, in theory at least, the economic principles of efficiency and equity suggest there is a straightforward case for treating all capital gains as income but there is also the third criterion mentioned above of administrative considerations. Needless to say, there would be practical difficulties in taxing capital gains in precisely the same way as other income. The first and most obvious difficulty concerns capital gains which arise only through increases in the price level. Such nominal gains do not, of course, increase an individual's real spending power and should not in principle be counted as income.

A second problem is that, in theory, CGT should be levied on an accruals basis. In practice this would involve the valuation of capital assets for each tax year, so imposing a considerable administrative burden. It would also involve the risk that individuals might be forced to liquidate assets in order to pay the tax which might involve undesirable outcomes regarding business assets. In the UK, CGT avoids such problems because it is levied on a realisation basis. However, this also presents challenges. Taxpayers might find themselves 'locked in', in the sense they have an incentive to postpone payment of the tax by not realising the asset even when it might otherwise be economically efficient to do so. Also, because assets are realised in uneven lumps, it is difficult to make the tax progressive. This difficulty may be aggravated because capital gains, whether realised or not, may occur irregularly.

Valuation can also be a consideration. Even with the realisation basis, it is necessary to determine the value of the asset when acquired and when realised. This will often be a straightforward exercise—it will simply be the value agreed between third party buyers and sellers. For other transactions, such as the sale of an asset originally received by way of gift, determining the value of the asset (in this case when received) may be more difficult.

3.2 The United Kingdom experience

Although there had been previous attempts to tax certain types of capital gains, especially from land, the systematic taxation of gains did not begin until 1962. In that year a tax on short-term gains was introduced. In 1965 a more comprehensive CGT came into operation. The tax is levied on a wide range of assets, but there are several exemptions, including a taxpayer's only or main residence, motor vehicles and gambling winnings. The justification for exempting the last of these was that, as there is no capital asset, there cannot be a capital gain. There is also an individual annual allowance of £11,100 (in 2016–2017 this was approximately \$26,500 NZ dollars).

In its early years, CGT was subject to a separate rate of tax, which was 30 per cent from 1965 to 1988. However, the argument that capital gains are a form of income

⁶¹ HC Deb 06 April 1965 vol 710 c245 245 § The Chancellor of the Exchequer (Mr James Callaghan).

and should be taxed accordingly eventually prevailed. In his 1988 Budget speech the Chancellor of the Exchequer stated:

In principle, there is little economic difference between income and capital gains, and many people effectively have the option of choosing to a significant extent which to receive. And in so far as there is a difference, it is by no means clear why one should be taxed more heavily than the other. Taxing them at different rates distorts investment decisions and inevitably creates a major tax avoidance industry. Moreover, at present, with capital gains taxed at 30 per cent for everybody, higher rate taxpayers face a lower—sometimes much lower—rate of tax on gains than on investment income, while basic rate taxpayers face a higher rate of tax on gains than on income. This contrast is hard to justify.⁶²

From 1988/89 onwards the rates of CGT were brought into line with those of income tax so that CGT was charged at the taxpayer's highest income tax rate. Nevertheless capital gains were still treated more favourably than other forms of income. As Robinson pointed out, even after the 1988 reform, CGT was payable in arrears, deferred on gifts, gave relief on retirement and exemptions on death.⁶³ After years of criticism of the inequitable effects of inflation on capital gains the government brought in a system of indexation based on the Retail Prices Index. This 'indexation allowance' gave relief for inflation between 1982 and 1998. From 1998 taper relief was introduced which reduced the amount of the gain according to the length of time the asset had been owned.

However in 2008 both taper relief and indexation allowance were withdrawn and the rate of CGT was changed from a person's top rate of income tax to a flat rate of 18 per cent. There were both winners and losers as a result of this change and after strong lobbying an entrepreneurs' relief was also introduced in 2008. This applied where, subject to certain restrictions, all or part of a business is sold and can reduce the effective rate of tax on some gains to 10 per cent. In 2010 a new rate of 28 per cent was introduced for capital gains of individuals with total taxable gains and income which put them in the higher rate income tax band (currently 40 per cent). In the 2016 Budget, with effect from April 2016, the government announced the reduction of the CGT rates from 18% and 28% to 10% and 20% for chargeable gains, except for residential property (other than the main or sole residence) and alternative investments such as private equity and hedge funds. Outlining the rationale for the policy change, HM Revenue and Customs (HMRC) stated:

The government wants to create a strong enterprise and investment culture. Cutting the rates of CGT for most assets is intended to support companies to access the capital they need to expand and create jobs. Retaining the 28% and 18% rates for residential property is intended to provide an incentive for individuals to invest in companies over property.⁶⁴

⁶² Hansard, 15 March 1988, col. 1005.

⁶³ Bill Robinson, 'Reforming the taxation of capital gains, gifts and inheritances' (1989) 10 *Fiscal Studies* 32–40.

⁶⁴ HM Revenue and Customs, *Policy paper: Changes to Capital Gains Tax Rates* (16 March 2016) <<https://www.gov.uk/government/publications/changes-to-capital-gains-tax-rates/changes-to-capital-gains-tax-rates>>.

Capital gains accruing to incorporated companies are also taxed but by corporation tax on their gains rather than CGT.

Although there have been several different ways of taxing a chargeable gain, the calculation of the gain itself has remained much the same. As one might expect, this is basically the sale proceeds less the purchase cost. One way in which the gain may work out to be smaller than at first expected is due to the sensible treatment of expenses. Those paid at acquisition are added to the original costs; those paid at disposal are deducted from the proceeds.

4. LESSONS FROM THE UNITED KINGDOM

4.1 Labour's capital gains tax policy—an introduction

Not unexpectedly the purpose of Labour's CGT proposal is couched in somewhat political and populist rhetoric. For example, comments in the 2011 policy statement such as '[t]his tax switch is about creating a fairer tax system' echo Adam Smith's equity canon for a good income tax⁶⁵ and resonate with commentators,⁶⁶ and groups such as the OECD⁶⁷ who have long highlighted the inequity present in the NZ tax system absent a comprehensive CGT. As noted from the UK Chancellor of the Exchequer's speech (referred to in Section 3.1 of this paper), equity concerns were pivotal to the introduction of a CGT in the UK.⁶⁸

The 11-page 2014 policy statement contains detailed discussion of aspects of the design features of the proposed CGT. The realisation-based CGT would apply to a wide range of assets and be levied at a single rate of 15% and with no tax-free threshold. Personal assets, collectables, small business assets sold for retirement and payouts from retirement savings schemes would be exempt from the CGT. The CGT would apply to gains accrued after implementation, that is, from a specific valuation date. Capital gains on inheritance passed on after death would be rolled over to the heir and CGT would be payable when the asset is realised. Capital losses would be carried forward and offset against future capital gains. Individuals classified as dealers would continue to be subject to income tax on such gains at their marginal tax rates. An Expert Panel would be established to deal with technical issues. The 2014 policy statement estimated the CGT would raise an additional \$1.035 billion in tax revenue by 2020/21.⁶⁹

The design of a comprehensive CGT for NZ could essentially proceed along two lines (or a combination of the two). First, the CGT could be developed on the basis of the strict (or close) adherence to the Haig-Simons concept of income, levied on an accrual

⁶⁵ Labour Party, above n 47, 4.

⁶⁶ See, for example, Chris Evans and Cedric Sandford, 'Capital Gains Tax—The Unprincipled Tax?' [1999] 5 *British Tax Review* 387, 403.

⁶⁷ OECD, above n 21, 24.

⁶⁸ A number of NZ reviews have also noted the importance of equity: Taxation Review Committee, *Taxation in New Zealand: Report of the Taxation Review Committee* (Government Printer, Wellington, 1967) [983] and Task force on Tax Reform, *Report of the Task Force on Tax Reform* (Government Printer, Wellington, 1982) [10.22]. Further, the Victoria University of Wellington Tax Working Group (TWG) in 2010 identified 'equity and fairness' generally as the policy reasons behind moves to broaden NZ's tax base: Centre for Accounting, Governance and Taxation Research, above n 12, 19.

⁶⁹ Labour Party, above n 48, 2.

basis with few, if any exemptions.⁷⁰ This form of CGT has been rejected by various NZ committees, let alone other countries including the UK, as unworkable. Second, (and the approach favoured by the authors) is that it could be based on a pragmatic approach which, considering broader tax administration, tax policy and design principles, departs from the comprehensive concept of income. Compromise and trade-off will be required under such an approach but hopefully will lead to a tax that is politically sustainable. Such an approach is contrary to that adopted by the GST where the policy design strongly focussed on simplicity but will be necessary for the successful implementation of a CGT.⁷¹

Labour's policy has taken certain administrative issues into consideration. As noted, the CGT would be levied on a realisation basis and will thus avoid both the burden of valuing assets annually and the potentially negative cash flow impact on taxpayer's required to fund an accruals-based tax. The policy trade-off will be the potential 'lock-in' of assets. Further, the tax base is not indexed for inflation. In a period of low inflation, as is the modern experience of most developed countries including NZ, this makes sense and avoids the practical compliance issues for taxpayers of indexation (and the consequent administrative impacts). Indeed, the 2014 policy statement acknowledges that indexation has been abandoned in the CGT regimes the United Kingdom and Australia due to its practical difficulties.⁷²

To reiterate, the purpose of this paper is not to comprehensively compare and evaluate Labour's CGT proposal with that adopted by the UK. Rather it aims to illustrate the potential importance of tax administration considerations and the interaction with tax policy and tax principles. The following Table summarises key characteristics of the UK CGT with the Labour Party policy, a number of which will be discussed later in this section.

⁷⁰ See, for example, Burman and White, above n 26, 355. Therefore, '[f]rom a design perspective, there should be no exemptions as having exemptions means opportunities for manipulation of the regime': Shaleshni Sharma and Howard Davey, 'Characteristics of a Preferred Capital Gains Tax Regime in New Zealand' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 113, 125.

⁷¹ Jeff Todd, 'Implementing GST—Information, Education, Co-ordination' in Richard Krever and David White (eds), *GST in Retrospect and Prospect* (Brookers Ltd, 2007) 31.

⁷² Labour Party, above n 48, at 5. Evans and Sandford also argue against indexation on the basis it does not exist for capital or income and there is no need in a low inflation environment: Evans and Sandford, above n 66, 404.

Table 1: Summary of CGT characteristics UK vs NZ Labour Party Policy

	UK	NZ
Introduced (general)	1965	Proposed
Implementation	From 6 April 1965	From specific date ('valuation day').
Tax Base	Capital gains realised on disposal of capital assets.	Capital gains realised on disposal of capital assets.
Separate Tax or part of the income tax code?	Separate—under the Taxation of Chargeable Gains Act 1992. Taxpayer required to file "supplementary page" (Capital gains summary, SA108) with income tax return as part of self-assessment.	No information.
Distinction between long term and short term gains (including tapering relief)	No—taper relief ceased from 5 April 2008.	No information.
Tax Rates	There is a flat rate of 18% for basic rate income taxpayers on capital gains net of any losses. For additional and higher rate income taxpayers the rate is 28%. Trustees pay 28% on capital gains and 10% for sole traders or partnerships if the gains qualify for Entrepreneurs' Relief. Companies pay corporation tax at 20% on gains not CGT. ⁷³ From April 2016 the CGT rates reduce to 10% and 20% for chargeable gains, except for residential property (other than the main or sole residence) and alternative investments such as private equity and hedge funds.	Flat rate of 15% for individuals. Expert Panel to consider CGT application to other entities including companies and trusts.
Indexation of cost base	No indexation relief since 6 April 2008.	No
Tax-free threshold (for capital gains)	Annual at £11,100 (for 2015–2016 and 2016–2017). Trusts £5,550. Adjusted from time to time.	No
Capital losses 'ring-fenced'?	Yes—offset against current and future gains indefinitely.	Yes - offset against current and future CGT liability. Expert

⁷³ As a matter of tax policy, the capital gains of a corporation are subject to corporation tax in full.

	UK	NZ
	Can be carried backwards for gains at death.	Panel to consider upper limit for offset of losses.
Treatment of gains at death	No CGT but rollover provisions for heirs and taxable at market value on realisation.	No CGT but rollover provisions for heirs and taxable at market value on realisation.
Treatment of gifts	Gifts subject to CGT unless to spouse, partner, civil partner or charity.	Gifts subject to CGT. Rollover where assets transferred between a couple in relationship break-up.
Private residence exempt?	Yes	Yes
Personal property exempt?	Yes—CGT on disposal of personal possession for £6,000 or more (eg jewellery, paintings, antiques, coins and stamps, sets of things such as matching vases or chessmen). No CGT on motor vehicles unless used for business and anything with a limited lifespan, eg clocks, unless used for business.	Yes - personal property (eg, boats, furniture, electrical goods, household items) and ‘collectables’ (eg, jewellery, antiques, artwork, stamp collections).
Treatment of savings schemes	No CGT on shares or units held in NISAs (New ISAs), ISAs (Individual savings accounts) or pensions.	Expert Panel to consider taxation of KiwiSaver and Portfolio Entity (PIE) ⁷⁴ funds. Pay-outs from retirement savings schemes, such as KiwiSaver exempt.
Other exemptions	UK government gilts and Premium Bonds, compensation for damages for personal or professional injury, betting, lottery or pools winnings.	Lump sum compensation (eg, redundancy, ACC or court awards), life insurance policy surrendered or sold, winnings or losses from gambling, medals.
Business relief	Yes—provided under the Entrepreneurs’ Relief which allows for a lower rate of CGT (10%) to be paid by people who have been with and employed by a trading company for more than a year and have at least a 5% shareholding. Claims may be made on more than one	Yes – gains up to a maximum of NZ\$250,000 for small business assets sold for retirement, where the owner is over a certain age (eg, 55) and has owned the business for 15 years and has been working in the business. Other rollovers not detailed – rollover where taxpayer disposes of one asset and replaces with a

⁷⁴ At present where a PIE has portfolio investment (that is, less than 10 per cent interest) in offshore companies the methods specified under the foreign investment fund (FIF) rules (such as comparative value) tax unrealised gains. The Expert Panel would need to grapple with integrating a realised CGT with the taxation of (unrealised) FIF income, with the attendant administrative and compliance issues this would raise. Investments in Australian-resident companies listed on an approved index of the Australian Stock Exchange are exempt from the FIF rules.

	UK	NZ
	occasion up to a ‘lifetime’ total of £10 million. Business Asset Rollover Relief – allows deferral of CGT if carrying on business and new business assets acquired within 3 years of disposal of old assets. Gift Hold-Over relief – no CGT where business assets are given away or sold for less than they are worth.	similar asset suggested in Labour policy statement.
CGT apply to non-residents?	Only on gains on sale of UK residential property made after 5 April 2015 (unless private residence exemption applies).	Yes – Expert Panel to consider details.
Persons migrating from the subject country	No deemed disposal on leaving the UK. No CGT charge unless legislation deems the departure to be an event giving rise to a deemed disposal.	Subject to CGT with the exception of land, buildings and business assets.

The remainder of this section critiques several key aspects of the design of Labour’s CGT with the UK experience, using a very ‘pragmatic’ approach. Due to limitations of space other aspects of CGT design pertinent to NZ, such as whether the tax is a separate tax with separate tax returns or is included in the income tax return, are not considered. Following the lead of Labour’s policy statements, this paper focusses on the application of the CGT to individuals and not entities.

4.2 Who pays the tax?

Echoing Sir Thomas White’s observation in Section 1 of this paper, Sharma and Davey in their NZ survey similarly observe: ‘[o]ne of the major challenges identified by 50 per cent of the participants is the negative public perception of CGT. Participants argued that people do not like to pay tax and CGT is another form of taxation’.⁷⁵ This emphasises the importance of the political sustainability of the tax. The 2014 policy statement estimates, based on Australia’s experience, that the CGT would impact in any one year on less than 10 per cent of taxpayers, or approximately 267,000 people, that is, ‘the few’.⁷⁶ At the outset of any future debate on a CGT in NZ, to ensure (ongoing) public support for a CGT, policy makers therefore need to clearly articulate the limited impact of the CGT. A full analysis should include the likely incidence of the tax rather than simply who ‘hands over the money’.

The inclusion of a tax-free threshold, as adopted in the UK, would further reduce the number of taxpayers subject to the tax, thus increasing its support (by ‘the many’). Support for a tax-free threshold (of \$10,000) was provided by interviewees in Sharma

⁷⁵ Sharma and Davey, above n 70, 132.

⁷⁶ Labour Party, above n 48, 2.

and Davey's NZ study.⁷⁷ There are two very practical tax administration impacts from the introduction of a tax-free threshold. First, it 'has the advantage of significantly reducing the operating ... costs related to the CGT, by eliminating the 'minnows and tiddlers' from the CGT net, without impugning the overall integrity of the regime'.⁷⁸ However, as previously indicated, this 'advantage' is actually a double-edged sword. From the perspective of the revenue authority it allows it to focus its activities on audit. As far as taxpayers are concerned, while it reduces the number of taxpayers subject to the tax, some taxpayers will still need to calculate the amount of any gain to determine whether the tax-free threshold applies. As noted in Section 1, for some taxpayers this will be straightforward, while for others it will be a time-consuming exercise. In the UK, for most taxpayers this is simply not an issue as they have no significant relevant capital gains.

The second tax administration impact of a tax-free threshold arises from the fact that in NZ individuals who are classified as a 'non-filing taxpayer' are currently not required to file a tax return. Typically such a person has all their annual gross income taxed at source and any interest or dividends will have resident withholding tax (RWT) deducted. The implementation of Labour's CGT (or an equivalent) would see this group required to file a tax return upon making a capital gain with the consequent costs this would entail. A tax-free threshold would ensure this group—to the extent they only make small capital gains—will retain their non-filing status. This has the advantage of reducing both compliance and administrative costs. On this point it should be noted that the NZ Inland Revenue (IR) has embarked on the 'Business Transformation programme'. This is a multi-year, multi-stage change programme seeks to 'modernise New Zealand's tax service to make it simpler and faster for New Zealanders to pay their taxes and give more certainty that they'll receive their entitlements'.⁷⁹ This programme is certain to have an impact on the 'non-filing taxpayer' category and their interaction with IR in the future.

It is important to note at this point that a tax-free threshold would not encourage economic efficiency as capital gains could still be favoured over income gains. As a general observation, economic efficiency can be more complicated if there are market imperfections to consider, in which case tax should not necessarily apply equally everywhere. Regarding thresholds the point is that there are trade-offs between economic efficiency in its pure form and other considerations. It may be preferable to have a CGT with a tax-free threshold (despite its compliance impact for some taxpayers) rather than no CGT because the lack of a tax-free threshold made it politically unacceptable—a point made by the TWG. In terms of economic efficiency, the tax-free threshold should apply to the net not the gross proceeds. Otherwise, for example, someone could be liable to CGT if their gross gains exceeded the threshold even if their net gains were below it or even negative as a result of capital losses elsewhere.

Finally, from the perspective of tax principles (equity) and political sustainability, a tax-free threshold could positively impact perceptions of greater progressivity,

⁷⁷ Sharma and Davey, above n 70,129.

⁷⁸ Evans and Sandford, above n 66, 404.

⁷⁹ Inland Revenue, *Business Transformation: About Business Transformation* (25 February 2015) <<http://www.ird.govt.nz/transformation/about-business-transformation/about-business-transformation-index.html>>.

especially if adopted in conjunction with a second, higher tax rate for capital gains above a specified threshold, as adopted in the UK (see Section 4.3).

4.3 Introducing progressivity

As outlined in Section 2.2, Labour proposes imposing a CGT at the flat rate of 15 percent on the net gain made by individuals. This rate compares with individual income tax rates on ordinary income in NZ which range from 10.5 per cent to 33 per cent⁸⁰ and ‘makes some allowance for the effect of inflation’.⁸¹ It also reflects that there is ‘often some risk associated with investment for capital gains as opposed to other investments.’⁸² The low CGT rate would reduce the risk of taxpayers holding onto assets, that is, ‘lock-in’ effects referred to above.⁸³

The UK, by way of contrast, taxes capital gains at one of three CGT rates.⁸⁴ Capital gains up to £11,100 are exempt from CGT. Prior to April 2016, individuals deriving gains above that threshold are subject to CGT at the flat rate of 18 per cent, or 28 per cent for individuals earning more than the income tax band of £31,785 (2015–2016 tax year) and £32,000 (2016–2017 tax year).⁸⁵ As noted in Section 3.2, as a tax policy measure CGT rates reduced to 10 per cent and 20 per cent for chargeable gains from April 2016. The previous, higher rates (18 per cent and 28 per cent) still apply to sales of residential property (other than the main or sole residence) and certain alternative investments. The three rate structure (plus the differential for owners of multiple residential properties) introduces progression into the CGT system, particularly incorporating elements of vertical equity. It is interesting to note that the UK has twice moved away from a flat CGT rate, in 1988 and 2010.

In the NZ context while the flat CGT rate proposed by Labour is lower than the tax rates on ordinary income, a situation which would not normally be viewed as increasing progressivity and meeting the principle of (vertical) equity, since NZ

⁸⁰ The NZ income tax rates for individuals are:

<i>Income bracket</i>	<i>Tax rate</i>
\$0–\$14,000	10.5 per cent
\$14,001–\$48,000	17.5 per cent
\$48,001–\$70,000	30.0 per cent
\$70,001 and over	33.0 per cent

⁸¹ Labour Party, above n 48, 5.

⁸² Ibid.

⁸³ Ibid.

⁸⁴ In fact, if the Entrepreneurs Relief, with a tax rate of 10% (see Section 4.7 of this paper), is included, there are in fact four CGT rates.

⁸⁵ The UK income tax rates for individuals for 2015/16 (2016–2017 in brackets) are:

<i>Income bracket</i>	<i>Tax rate</i>
£0–£31,785 (£0–£32,000)	20 per cent
£31,786–£150,000 (£32,001–£150,000)	40 per cent
Over £150,000	45 per cent

In addition, there is a personal allowance of £10,600 and £11,000 for 2015–2016 and 2016–2017, respectively.

presently does not tax capital gains, this is a move toward vertical equity.⁸⁶ However, equity concerns remain. While there is clear rationale for the 15 per cent CGT rate, the low rate ‘negates many of the benefits of introducing the tax’.⁸⁷ The reality is that as it is lower than three of the present four tax brackets for individual taxpayers—in fact, half or less than the top two rates—an arbitrage opportunity will exist between income from capital and income from labour. This will lead to horizontal inequity and impact on the administration of the tax. The difficulties that exist in differentiating between income and capital in the current NZ tax system absent a CGT ‘will continue to be perpetuated despite the introduction of a CGT’⁸⁸ under Labour’s proposal. In addition, on the basis that capital gains tend to be derived by higher wealth individuals, the effective concessional tax rate for capital gains will benefit that group more.

In terms of tax design, these equity concerns could be addressed to a degree in NZ through the adoption of a more progressive CGT scale as utilised in the UK. This could be achieved through the adoption of two measures, the first, discussed in Section 4.2 of this paper, is the introduction of a tax-free threshold. The second measure would incorporate into the CGT regime at least one additional tax rate for capital gains above a certain level. As a variation of this, to further address issues of equity, a higher rate(s) could apply to owners of multiple residential properties—the approach recently adopted in the UK for tax policy reasons.

Introducing differential CGT rates, based on the level of capital income and/or number of properties, will have trade-offs. While it focusses on the tax principle of equity, the complexity of the CGT will increase which will impact on the administration of the CGT, particularly for taxpayers in determining their actual CGT liability. Tax returns and the tax system would need to accommodate any such measures (including the need for potential audit activities). To avoid imposing such levels of complexity capital gains could be treated as ordinary income subject to the existing individual income tax rates. In addition, rather than, for example differential rates for multiple properties, capital gains could potentially be taxed at varying percentages to reflect factors such as risk, inflation and the number of properties. An integrated system would have tax administration savings in terms of tax returns and the tax system. However, as NZ does not have a tax-free threshold for ordinary income, unlike Australia for example, under this approach all capital gains would be subject to tax (unless a specific zero-rate was implemented) which would significantly impact on the administration of the income tax (for example, for those currently classified as non-filing) and the political sustainability of the CGT. If such an approach also included the application of varying percentages to reflect the factors mentioned such as risk, this would introduce further complexity into the determination of a taxpayer’s CGT liability and underline the administrative benefits of integrating the CGT with income tax.

⁸⁶ This impact on progressivity is acknowledged by the New Zealand Treasury in July 2013 who observed that a CGT could have (positive) implications for both horizontal and vertical equity; with respect to the latter probably making the tax system more progressive: The Treasury, *Affording Our Future—Statement on New Zealand’s Long-Term Fiscal Position* (Wellington, July 2013) 27 <<http://www.treasury.govt.nz/government/longterm/fiscalposition/2013/affordingourfuture/lfts-13-aof.pdf>>.

⁸⁷ Cassidy and Alley, above n 32, 120.

⁸⁸ Ibid.

As a consequence, and as indicated in Section 4.2, the authors favour a separate CGT with a tax-free threshold. This will ensure a level of progressivity with the CGT. Multiple CGT rates could also be introduced depending on the strength of the equity concerns to be addressed by the CGT. However, in addition to the complexity and tax administration issues noted above, differential rates could also encourage manipulation to avoid the higher rate(s). Therefore any decision to include more than one CGT rate will require careful consideration.

4.4 Tax appeasement—the main residence exemption

In line with the UK (and other CGT regimes), Labour's 2014 policy statement provides an unlimited exemption for the main residence. This tax policy measure reflects overseas experiences that suggest 'an exemption for the primary residence is needed in order to garner support and make the introduction of a CGT politically palatable'.⁸⁹ Holiday homes would be included as part of the CGT regime (except where passed down from one generation to another) as to exempt them would lead to loopholes, as well as definitional and administrative issues.⁹⁰ Where the main residence was also used for business purposes, there would be a partial exemption from the CGT for that portion of the property used as the family home.⁹¹ Similarly, in respect of farms, the primary farm residence and surrounding land used for domestic purposes (the curtilage) would be exempt from CGT⁹² while the land used in the farming business would be subject to the tax.

The exemption of the primary residence is contrary to the comprehensive concept of income and reduces the revenue to be raised from the tax.⁹³ Huang and Elliffe note that the unlimited (in terms of dollar amount) exemption in Australia 'has caused significant loss to the CGT base'.⁹⁴ Whether such an exemption is included in a future NZ CGT requires a consideration of, and trade-off, between tax principles and tax administration. The unlimited exemption would advantage wealthier taxpayers who typically own more expensive homes, hence having a negative impact on equity. In addition, it could be economically inefficient by favouring investment in private residences over other investments. If the focus is on addressing concerns over tax principles (that is, equity and economic efficiency) there are three alternative approaches to implementing an unlimited exemption for the main residence. The first approach would be to have no exemption at all—a politically unpalatable approach. The second approach, a variation of which was practised by the US prior to the enactment of the current exemption in 1997, is the deferral of the gain where the proceeds (up to the amount of the gain) are rolled over into the acquisition of a new

⁸⁹ Jacob Spoonley, 'A Sanctuary from the Taxman? The Design of the Primary residence Exemption' (2015) 21 *New Zealand Journal of Taxation of Law and Policy* 69.

⁹⁰ Labour Party, above n 48, 7.

⁹¹ Ibid 8.

⁹² Ibid 7.

⁹³ Estimates are that owner occupied housing accounts for two-thirds of the property market: Rob Hosking, 'Officials raise land tax idea again', *The National Business Review* (online), 10 December 2012. Shewan has estimated that the revenue from a CGT in NZ would drop from \$8.89 billion annually to \$4.54 billion annually if owner-occupied housing was excluded: Shewan, at slide 6, as cited in Spoonley, above n 89, 86.

⁹⁴ See Peter Abelson and Roselyne Joyeux, 'Price and Efficiency Effects of Taxes and Subsidies for Australian Housing' (2007) 26 *Economic Papers: A Journal of Applied Economics and Policy* 147, 150, as cited in Huang and Elliffe, above n 32, 296.

main residence.⁹⁵ In the US context, the deferral was only available where a new residence of equal or greater value was acquired. As a result the deferral was criticised on the basis that, as it locked-in taxpayers, it was a significant barrier to mobility.⁹⁶ It accordingly caused distortions in a homeowner's purchasing decisions, including the elderly, and thus violated the principle of economic efficiency.⁹⁷ The issues referred to in the US context (such as lock-in and economic inefficiency) would still arise in the absence of any restrictions on the value of the newly acquired residence (although perhaps be less pronounced), for example where, as noted by Spoonley above, a taxpayer wishes to no longer own a home but intends to rent. The third option to address concerns over tax principles would be to limit the exemption to a specific amount with gains above that predetermined threshold subject to CGT. This latter approach has been adopted in the US⁹⁸ and more recently South Africa.⁹⁹ Spoonley notes that a limited exemption 'provides a significant opportunity to contribute greater vertical equity and progressivity'.¹⁰⁰ Against this, there is the need to address administrative considerations. A CGT is complex. A minimum exempt threshold or rollover option would add a further layer of complexity and consequent additional costs, both of a compliance and administrative nature. By contrast, a blanket exemption reduces the required audit focus of the revenue authority and tax compliance required of taxpayers. On the basis of tax administration savings, and to ensure electorate support (political sustainability), despite the impact on equity and economic efficiency, an uncapped exemption for the main residence (as adopted in the UK) may be preferable.

⁹⁵ This approach is currently used in Sweden for example: PWC Sweden *Individual—Income Determination* (23 August 2016) <<http://taxsummaries.pwc.com/uk/taxsummaries/wwts.nsf/ID/Sweden-Individual-Income-determination>>.

⁹⁶ Spoonley, above n 89, 87. In this respect, Spoonley notes for example that CGT would arise on the difference in the cost of housing "where a taxpayer wanted to downsize from owning a home to renting, or if they were required (due to employment or personal circumstances) to move to another part of the country that had lower house prices.": *ibid* 88.

⁹⁷ "Since homeowners could not downsize their housing as family sizes decreased, the rollover provision often forced them to purchase larger and more expensive homes than needed": Pete H Oppenheimer 'The Taxpayer Relief Act of 1997 and the Housing Boom of the 21st Century' (2014) 16 *Journal of Applied Business and Economics* 112, 113.

⁹⁸ In the United States, a person's main personal resident is not excluded from capital gain treatment, but there is a USD 500,000 exemption (for married filing jointly and USD 250,000 for single taxpayers), subject to certain conditions including living in the home for a specified period: Spoonley, above n 89, 76. This capped threshold was introduced, at this level in 1997 and has not increased. When enacted it was generous, being 'set well above the median house price at the time': *ibid*.

⁹⁹ South Africa's regime exempts gains on primary residences up to ZAR 1.5 million: Huang and Elliffe, above n 32, 296. At the time of writing, ZAR 1.5 million is equivalent to NZD 141,402 (23 May 2016). Alternatively, CGT could be deferred through roll-over: Evans and Sandford, above n 66, 404. In reality, Spoonley concludes that from a tax design perspective horizontal equity improvements from a capped exemption are 'only small': Spoonley, above n 89, 74. Spoonley also cites Jane G Granville and Pamela J Jackson, 'The Exclusion of Capital Gains for Owner-Occupied Housing' (RL32978, Congressional Research Service, 26 December 2007) 7, who acknowledge that in the US the capped exemption 'has not reconciled inequities between homeowners with different job circumstances, between those who live in different parts of the country, and between those with different health needs'. They do note, with the exception of regional-based inequities, allowances for certain taxpayers can address inequities related to job and health circumstances: Spoonley, above n 89, 7.

¹⁰⁰ Spoonley, above n 89, 74. In support, Spoonley cites for example Richard Krever and Neil Brooks, *A Capital Gains Tax for New Zealand* (Victoria University Press for the Institute of Policy Studies, 1990) 93.

4.5 Attracting tax investment or tax preference—residential property and non-residents

Labour's 2014 policy statement provides that, in principle, non-residents will be subject to the CGT in the same way as NZ resident taxpayers.¹⁰¹ Elliffe¹⁰² observes that 'many other countries do not tax non-residents on the sale of personal property and, in particular, shares in companies resident in their country, where the income could be said to have a source in their jurisdiction'.¹⁰³ The issue from a tax policy perspective with a non-comprehensive CGT regime is that it could give foreigners a tax advantage that cannot be enjoyed by NZ residents.¹⁰⁴ However, the argued benefit for countries such as Australia, which have narrowed the range of assets for which a non-resident may be subject to CGT, is to enhance the status of that country as an attractive place for investment and business.¹⁰⁵ This is a difficult policy issue.

The CGT in the UK does not generally apply to non-residents. However, recent changes in this respect in the UK may be instructive from a design perspective. As a result of legislative amendments, UK residential property disposals by UK non-resident individuals may be subject to CGT on any gains made on disposals made after 5 April 2015. A non-resident will pay CGT on the gain from the sale of a UK residential property that is not their main home, or their main home if it is let out, if they have used it for business, had long periods of absence or the home is very large. The measure will increase compliance and administrative costs, however, in this case tax principles and policy have trumped tax administration impacts. The HM Treasury Autumn Statement 2013¹⁰⁶ announcing this extension of the CGT stated that, *inter alia*, the change was to 'ensure that those with the most in society make a *fair contribution*',¹⁰⁷ a reference to equity. Related to this, and reflecting policy concerns, it was also reported that the measure was aimed at curbing soaring house prices¹⁰⁸ which impacts greatest on lower-income and first-home buyers. In addition, from a broader tax policy perspective the change 'is intended to harmonise the UK system with other jurisdictions that charge tax on the basis of where the property is located rather than where the owner is resident'. This change to the taxation of real property owned by non-residents will broadly align the UK position with to the US, South Africa and Canada.¹⁰⁹

New Zealand house prices (particularly in Auckland)¹¹⁰ have grown strongly in recent years. Among the reasons cited include the impact of speculators, investors and

¹⁰¹ Labour Party, above n 48, 11.

¹⁰² Craig Elliffe, 'Key Issues in the Design of Capital Gains Tax Regimes: Taxing Non-Residents' (2015) 21 *New Zealand Journal of Taxation Law and Policy* 90.

¹⁰³ *Ibid* 93.

¹⁰⁴ *Ibid*.

¹⁰⁵ *Ibid* 94.

¹⁰⁶ HM Treasury, *Autumn Statement 2013* (HM Treasury, United Kingdom, December 2013) <https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf>.

¹⁰⁷ *Ibid* 9. Emphasis added

¹⁰⁸ 'Britain to tax foreign property investors from 2015—Osborne', *Reuters.com* (online), 5 December 2013.

¹⁰⁹ Elliffe, above n 102, 94.

¹¹⁰ Suze Metherell, 'House Prices Rise at Fastest Pace in Nine Years', *NBR* (online), 3 November 2015 <http://www.nbr.co.nz/article/house-prices-rise-fastest-pace-9-years-b-181041?utm_source=newsletter&utm_medium=email&utm_campaign=NBR%2520Property%2520-%25207-Day%2520Wrap>.

foreign investors in the market.¹¹¹ From a tax policy perspective, measures such as those introduced into the UK with respect to non-resident property owners would sit well in the NZ context in terms of the political viability of the CGT given housing affordability issues and broader equity concerns. However, the benefit of this measure, at least in the NZ context, may primarily be symbolic as the impact foreign speculators have had on house prices compared with, for example, lack of supply and increasing immigration into NZ, is unclear.¹¹²

4.6 Compliance and administrative cost minimisation—personal use property

The Labour Party proposal would entirely exempt items such as boats, furniture, electrical goods and household items (termed ‘personal property’)¹¹³ along with ‘luxury’ items such as ‘the millionaire’s super yacht’.¹¹⁴ The policy rationale for this exemption is that such assets (especially luxury items) tend to depreciate over time and to levy the CGT on such items would provide a tax incentive due to the ability to write off capital losses (against capital gains).¹¹⁵

‘Collectables’ such as jewellery, antiques, artwork, rare folios or stamp collections would also be exempt unless the person is a trader.¹¹⁶ Taxpayers who regularly trade in these items (and personal property)¹¹⁷ would continue to be assessed on their profits as ordinary income under existing sections in the *Income Tax Act 2007*.¹¹⁸

The exemption for collectables makes sense from a tax administration perspective. First, a CGT on these items would be intrusive (and lead to resentment among taxpayers at the invasion of their privacy). Second, it would result in high compliance costs and administrative costs and, finally it would not raise significant revenue (especially when compared with the related compliance and administrative costs).

However, the exemption also needs to be considered in the light of good tax policy design as the likely behavioural response of taxpayers will be to invest in these types of assets. Collectables, such as artworks and antiques, tend to be owned by higher wealth individuals and appreciate in value. Labour’s policy, in this respect, is therefore contrary to its overall objectives for implementing the tax—‘creating a fairer tax system’¹¹⁹—as essentially it provides a tax break for (generally higher wealth) owners of these assets. The broader question that also needs to be answered is

¹¹¹ ‘Tighter Rules on Residential Property Investors and Overseas Buyers’, *The National Business Review* (online), 17 May 2015 <<http://www.stuff.co.nz/business/68612603/tighter-rules-on-residential-property-investors-and-overseas-buyers>>.

¹¹² New disclosure requirements apply to foreign purchasers of residential properties in NZ from 1 October 2015. Data released by Land Information New Zealand shows that 3 per cent of houses sold between January and March 2016 went to people who were not NZ citizens, or holders of a residency, student or work visa. The data is limited both in terms of the period covered and limitations of the disclosure rules, Isaac Davison, ‘The Truth About Foreign Buyers’, *The New Zealand Herald* (online), 10 May 2016 <http://m.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11636711>.

¹¹³ Labour Party, above n 48, 6.

¹¹⁴ Ibid 4.

¹¹⁵ Ibid.

¹¹⁶ Ibid 4, 6.

¹¹⁷ Ibid. Transactions in respect of land are covered by a separate suite of sections in the *Income Tax Act 2007*, ss CB 6A – CB 23.

¹¹⁸ See, for example, s CB 5 of the *Income Tax Act 2007* (NZ).

¹¹⁹ Labour Party, above n 47, 4.

whether investment in such collectables is to be encouraged. As a tax policy consideration, arguably these are generally not the types of assets that a nation wants to incentivise investing in; instead, tax policy should focus investment into productive sectors of the economy, encourage investment and innovation as well as the creation of jobs. One of the key reasons a CGT is promoted by Labour (along with some commentators) is that it ‘will help shift the focus of investment from speculation on property to the productive export sector’.¹²⁰ The exemption of collectables is clearly contrary to that policy and will not improve economic efficiency but lead to further investment in non-productive assets. This approach is also a departure to the general NZ approach to tax policy which aims to take tax ‘out of the equation’ and ensure it is not a disincentive to investment.

The UK has adopted a more restrictive approach, in particular with what equate to ‘collectables’ under Labour’s 2014 policy statement. Individuals are liable to CGT if their gain on sale of a personal possession is £6,000 or more. Personal possessions include jewellery, paintings, antiques, coins and stamps and sets of things, for example, matching vases or chessmen. There is no CGT on a car (unless it has been used for business) or anything with a limited lifespan, for example, clocks, unless used for business. An individual is exempt from paying CGT on the first £6,000 of their share if they own a personal possession with other individuals. The inclusion of an exempt threshold has three benefits. First, as a matter of tax principle, taxing gains over a certain level maintains a measure of progressivity with the CGT system for this class of asset. Second, reflecting political realities, it recognises that a wide range of individuals may ultimately own these assets, perhaps through obtaining by inheritance, including those on lower incomes. Third, from a tax administration perspective the threshold eliminates the potential compliance and administrative costs for smaller transactions. However, as already noted the inclusion of a tax-free threshold will require some taxpayers to determine whether they satisfy the particular concession, potentially imposing compliance costs on these taxpayers.

In terms of tax principles, if any future CGT in NZ is to encourage greater equity and economic efficiency in the tax system, it should apply to collectables. As mentioned, this would make the CGT more progressive as these assets tend to be owned by wealthy individuals. To ease tax administration issues, smaller gains could be excluded either by a targeted threshold as in the UK or to the extent any gains come within the general tax-free threshold (assuming one exists, as discussed in Section 4.2 of this paper). However, this overall approach will also have negative implications for tax administration. Taxpayers buying and selling collectables will be incentivised to adopt the position that they are not dealing and are therefore subject to the CGT (including any exempt threshold) and not income tax. While a similar incentive presently exists and there is case law which considers the characteristics of a dealer, the boundary (of who a dealer is) will come under greater pressure with the consequent effect on the administration of the tax by Inland Revenue.¹²¹ The same incentive arises in respect of gains from the sale of personal property outside the collectable (and personal use) category except where a loss arises, in which case a taxpayer would want to adopt the converse position (and offset the loss against ordinary income). The incentive to undertake such positions will negatively impact on

¹²⁰ Ibid 15.

¹²¹ Maples, above n 23, 161.

the administration of the tax. Despite this a UK approach to ‘collectables’ can be justified when the focus is on tax policy and tax principles.

An alternative approach to address the concerns over determining who is (or is not) a dealer, would be to treat all gains from the disposal of personal property as ordinary income subject to income tax. While this would remove the boundary issues referred to above, and therefore positively impact on one aspect of the administration of the tax, in the absence of a tax-free threshold for ordinary income, this treatment would also impose compliance costs on taxpayers deriving small gains and administrative costs for Inland Revenue. This, in turn, would undermine the political sustainability of any such measure.

4.7 ‘Remember the little fella’—business concessions

The 2014 policy statement proposes the exemption of ‘[s]mall business assets, up to a maximum of \$250,000, sold for retirement, where the owner is above a certain age (e.g. 55) has held the business for 15 years and has been working in the business’.¹²² The term ‘small business’ is not defined. This and other details would be considered by the Expert Panel in consultation with the small business community.¹²³ The concession would also apply to the sale of farming businesses.

From a tax administration perspective any such exemption has the potential to create additional complexity, irrespective of how the term ‘small business’ (or equivalent) is defined and will lead to taxpayers attempting to structure into the provision. A specific anti-avoidance provision would be required to prevent this. This in turn would impact on tax compliance and administrative costs. In addition, any threshold would require monitoring by future governments to ensure it retains its currency and the policy goals of the concession continue to be met.

Labour justifies the exemption on the basis that it ‘means that those who have saved through investing in a small business will not be negatively disadvantaged’.¹²⁴ The argument goes that for many of these enterprises the owner’s resources are invested in the business and thus it is their de facto retirement savings vehicle. Further, it is unlikely that they will have made separate provision for retirement via a savings scheme. While as a part of good tax policy the CGT should not penalise investment generally and, specifically those making provision for their retirement through running a small-to-medium enterprise (SME) should not be disadvantaged, this exemption in fact favours this form of retirement saving and has negative implications for equity and efficiency. New Zealand taxes savings on a ‘taxed-taxed-exempt’ (TTE) basis (on accrual). This means that contributions are made out of after-tax income, any gains are taxed at the time they are earned, and all withdrawals are tax-free. To the extent that the gain from a business is exempt from the CGT, it can be seen as being treated on an exempt-exempt-exempt (EEE) basis as the expenditure to develop and to grow the business is typically deductible. Evans and Sandford argue in support of relief from CGT for disposal of a business or its assets to fund retirement ‘*assuming* that concessional tax treatment is also available to other taxpayers who save—voluntarily

¹²² Labour Party, above n 48, 6.

¹²³ Ibid 7.

¹²⁴ Ibid 6.

or forcibly—to fund their retirement, and subject to the caveat that the CGT-free business disposals be integrated with the superannuation/pensions system’.¹²⁵

Due to these equity and efficiency issues, in the absence of such concessional tax treatment being extended to other forms of saving, the principal justification for Labour’s small business concession is political sustainability recognising the reality that NZ is a nation of small businesses. It is estimated that there are 460,000 SMEs in NZ.¹²⁶ SMEs make up about 97 per cent of businesses in NZ, and almost 70 per cent of them are single-worker businesses. Support for a CGT among businesses has been far from universal with one poll suggesting that ‘60 per cent of small and medium-sized business owners are negative about the Labour Party’s [2014] capital gains tax’.¹²⁷ Policies which recognise these political realities will be important for the support for, and success of, any CGT proposal in NZ. There are also tax policy grounds to support this concession. In addition, on the basis that SMEs face high (regressive) tax compliance costs,¹²⁸ there are tax policy arguments in support of any measures that can address or minimise any such costs for SMEs.

Labour’s small business exemption raises two issues, assuming that the decision is made to proceed with it.¹²⁹ First, given the objective of political sustainability and therefore to limit the inevitable lobbying over the level of the exempt threshold, should the exempt amount be higher? Second, does the exemption need to be extended, for example, should other forms of (small) business relief be considered to encourage investment and innovation?

The UK has adopted a broader set of business concessions, largely for reasons of political sustainability. As a general observation, the relief available is not limited to retirement and includes the following. First, the Entrepreneurs’ Relief allows for a lower rate of CGT (10 per cent) to be paid on gains arising from the sale of certain business assets by individuals who have been with and employed by a trading company for more than a year and have at least a 5 per cent shareholding. Claims may be made on more than one occasion up to a ‘lifetime’ total of £10 million.¹³⁰ In addition, Business Asset Rollover Relief allows for the deferral of CGT on sale of a business asset if a person is carrying on a business and new business assets are

¹²⁵ Evans and Sandford, above n 66, 405.

¹²⁶ ‘SMEs Still Backbone of NZ Business’, *Stuff* (online), 25 June 2014 <<http://www.stuff.co.nz/business/small-business/10198006/smes-still-backbone-of-nz-business>>.

¹²⁷ ‘Small Business Owners Negative On Capital Gains Tax survey’, *The New Zealand Herald* (online), 5 September 2014) <http://www.nzherald.co.nz/business/news/article.cfm?c_id=3&objectid=11319576>.

¹²⁸ Chris Evans and Binh Tran-Nam, ‘Tax Compliance costs in New Zealand: An International Comparative Evaluation’ *Tax Administration for the 21st Century Working Papers* (Victoria University of Wellington, 2014), 14, 28.

¹²⁹ Interestingly, 67.5 per cent of those interviewed by Sharma and Davey did not advocate exemptions for small or new businesses in NZ on the basis such an exemption could be manipulated: Sharma and Davey, above n 70, 129. In addition, the interviewees ‘argued that the size of the business is irrelevant to the imposition of and liability to pay CGT; otherwise, the effects of CGT are watered down which defeats the purpose of having CGT in the first place’: *ibid*.

¹³⁰ HM Revenue and Customs, *Guidance: HS275 Entrepreneurs’ Relief* (2015) <<https://www.gov.uk/government/publications/entrepreneurs-relief-hs275-self-assessment-helpsheet/hs275-entrepreneurs-relief-2015>>. The 2016 Budget made a number of changes to the relief, such as extending it to long-term investors: HM Revenue and Customs, *Personal Tax—Policy Paper Capital Gains Tax: Entrepreneurs’ Relief: Extension to Long-term Investors* (16 March 2016) <<https://www.gov.uk/government/publications/capital-gains-tax-entrepreneurs-relief-extension-to-long-term-investors>>.

acquired within 3 years of the disposal of the original assets. Further, under the Gift Hold-Over relief, no CGT arises where business assets are given away or sold for less than they are worth.

Evans and Sandford argue on equitable grounds that rollover ‘provisions need to exist where involuntary disposals occur (compulsory acquisitions, corporate takeovers and mergers, destruction of assets through natural disasters, etc)’.¹³¹ Similarly, on efficiency grounds they argue ‘for deferral of the capital gain where taxpayers are rolling the proceeds of the disposal of one asset into a bigger asset, in order to grow a business’.¹³²

Aside from Evans and Sandford’s arguments in favour of the very specific concessions referred to above, based on equity and efficiency considerations, broader business concessions than those proposed by Labour, potentially modelled on the UK concessions, are warranted on the basis of political sustainability. However, even here the grounds for special treatment come with a ‘health warning’. Quintal, Snell and Chan sound a cautionary note in respect of rollover relief for reinvestment: ‘the extent to which investment, entrepreneurship and divestment should be encouraged appears something of a political football. That leads to a shifting, overlapping and poorly enforced range of reliefs and concessions’.¹³³ Further, any such concessions will also need to acknowledge that there will be a trade-off in the form of tax administration impacts. Cassidy and Alley argue that rollovers and exemptions generally ‘necessitate the introduction of anti-avoidance measures which add to complexity of the provisions’.¹³⁴

5. CONCLUSION

Tax administration covers a range of aspects of taxation and includes the development and formulation of tax policy in relation to tax legislation. As noted at the commencement of this paper, in developing tax design, tax principles are a valuable guide. However, the optimal outcome may require modification in the light of tax policy and the reality of tax administration. In addition to these three dimensions of tax reform, it is also important that any tax reform is politically sustainable.

The overarching policy underpinning the design of the NZ tax system is that it should have a broad-base, low rate tax structure. In practice this means a focus on the principles of simplicity and convenience—New Zealand’s very successful GST is a good example of this policy. In an ideal world the design of a CGT should complement the BBLR approach. However, the long-standing antipathy against a CGT means that policymakers will need to address key electorate concerns for a CGT to be politically sustainable in NZ, both prior to and after its implementation. As posited in Section 2.0 of this paper, the lack of consideration of tax administration aspects of a possible CGT in the various reports and Labour’s policy statements may go some way to explain the hostility to the tax. Therefore in designing a future CGT policymakers will need to balance good tax design principles with tax administration considerations. This will be a challenge. At a practical level a departure from the

¹³¹ Evans and Sandford, above n 66, 404.

¹³² Ibid.

¹³³ Quintal, Snell and Chan, above n 15, 19.

¹³⁴ Cassidy and Alley, above n 32, 99.

BBLR and its consequential focus on simplicity and broad coverage will therefore be required. It is clear from a consideration of the UK CGT regime that it introduces significant additional complexity into the tax system, due in part to policymakers introducing specific concessions. While in a 'pure' system such exemptions and concessions should be limited to minimise complexity and opportunities for tax planning, from an administration perspective there are strong arguments for some relief, such as a tax-free threshold, to reduce compliance and administrative costs.

As noted earlier in this paper, its purpose is not to evaluate Labour's CGT proposal comprehensively but, in the context of the UK, to consider the interplay between tax policy, tax principles and tax administration. Accordingly, the paper does not conclude with detailed recommendations on the design of a CGT. However, based on the discussion in the paper, the authors support the inclusion of a tax-free threshold in any future NZ CGT. While it would narrow the tax base and create complexity for those taxpayers required to determine its application, it would have tax administration benefits for Inland Revenue and taxpayers deriving small gains. In addition, it would introduce a measure of progressivity (equity) into the CGT. This measure, along with an uncapped exemption for the main residence reflect that successful tax policy must take account of political reality. While, from the perspective of tax principles (equity and economic efficiency) an uncapped exemption for the main house would have negative implications, not to have such an exemption would impact on tax administration and could undermine the political sustainability of the tax leading to pressure on subsequent governments to introduce such a threshold. Subjecting non-resident taxpayers to a CGT could have advantages from a tax principles/policy perspective but lead to increased administrative and compliance costs. On the basis of similar arguments to those raised above with respect to a tax-free threshold (including tax administration benefits), a limited exemption for personal use property could be included in the CGT. New Zealand has a large number of SMEs. Driven by the political sustainability concerns, a future CGT should consider concessions for this group, for example on retirement.

The success of a CGT, or any tax, will therefore *inter alia* depend on a clear policy rationale which informs the design, consultation and implementation phases:

Should New Zealand introduce a CGT merely to introduce a CGT, the CGT is likely to miss the mark and will be subject to constant remedial changes. During the design process, New Zealand needs to define the problem(s). The CGT then needs to be designed with the specific problem(s) in mind.¹³⁵

However, the design process should not simply focus on good tax principles but also tax administration considerations.

Ministers of Parliament and officials will face heavy lobbying from sector groups if, and when, a CGT finally receives the 'go ahead'. At that point it will be crucial that the objectives of the CGT are clear and that the administration issues of the tax are given due consideration along with principles of a good tax design. Policymakers

¹³⁵ Brad Bowman, 'Capital Gains Tax: Setting a Good Foundation (Before the Inevitable Squabble)' (2014) 78 *Taxation Today* 13, 14.

should keep in mind Gammie's caution: '[a CGT] is a compromise, and, as is so often the case with a compromise, it functions badly and pleases no one'.¹³⁶

The near future would be an ideal opportunity to implement a CGT in NZ as the Inland Revenue has embarked on the Business Transformation programme (referred to in Section 4.0). This 10-year programme¹³⁷ involves changes that 'will simplify and streamline [Inland Revenue's] business processes, policies and customer services as well as upgrade [Inland Revenue's] technology platform'.¹³⁸ Any future CGT design should benefit from the fruits of the Business Transformation programme with its focus on tax administration considerations.

The introduction of the goods and services tax in NZ in 1986 'suggests that a politically controversial new tax can be implemented in New Zealand, with exemptions that depart from the theoretical ideal, but not disintegrate over time'.¹³⁹ New Zealand is in a unique position. 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.

¹³⁶ Malcolm Gammie, 'Taxing Capital Gains—Thoughts from the UK' (2000) 23 *University of New South Wales Law Journal* 309.

¹³⁷ Paul McBeth, 'IRD's Business Transformation Project to Come in Under Budget', *The National Business Review* (online), 11 November 2015 <<http://www.nbr.co.nz/article/irds-business-transformation-project-seen-coming-under-1-billion-b-181435>>. In fact, the programme is ahead of schedule and may be completed in 7 years.

¹³⁸ Inland Revenue, above n 79.

¹³⁹ Huang and Elliffe above n 32, 304.